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91 1062

No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

IVAN AND JOANNE SCHATZ,

Petitioners,

v.

WEINBERG AND GREEN,

Respondent.

**Petition for a Writ of Certiorari
To the United States Court of
Appeals for the Fourth Circuit**

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QUESTIONS PRESENTED

1. Whether attorneys who knowingly assist their clients in perpetrating a fraud should be exonerated from liability under the Federal Securities laws, specifically, Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5 promulgated thereunder, on the grounds that the attorneys owed no duty to third parties.

2. Whether attorneys who knowingly assist a client in carrying out a fraudulent stock sale transaction should be liable under the Federal Securities laws as aiders and abettors of a fraud where,

(1) the attorneys had actual knowledge of the fraud and,

(2) prepared legal documents perpetuating the fraud.

3. Whether attorneys have a duty under the Federal Securities laws not to knowingly restate or perpetuate their clients' misrepresentations.

LIST OF PARTIES

The Plaintiff-Petitioners are Ivan and Joanne Schatz, husband and wife. The Defendant-Respondent is Weinberg and Green, a law firm based in Baltimore, Maryland. There were three other defendants in the District Court who settled with Plaintiffs and were not involved in the appeal to the Court of Appeals and are not respondents herein. They are Mark E. Rosenberg, Stephen Jaeger, and MER Enterprises, Inc. MER Enterprises, Inc. has no parent companies, subsidiaries or affiliates and is not publicly traded.

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DECISIONS BELOW

The opinion of the Fourth Circuit Court of Appeals, *Schatz v. Rosenberg,* 943 F.2d 485 (4th Cir. 1991) is appended (app. pp. 1-50). The unreported opinion and order of the District Court for the District of Maryland both initially (app. pp. 136-157) and upon reconsideration (app. pp. 158-161) and the report and recommendation of the U.S. Magistrate (app. pp. 51-135) are also appended.

JURISDICTION

The opinion of the Court of Appeals was filed on August 26, 1991. A timely petition for rehearing was

filed on September 9, 1991. The petition for rehearing was denied by the Court of Appeals by order of October 1, 1991. A copy of this Order is appended (app pp. 161-62). This Court has jurisdiction under 28 U.S.C. § 1254.

STATUTES INVOLVED

The relevant statutes are Section 10(b) of the 1934 Securities Exchange Act, 15 U.S.C. § 78j(b) and Rule 10b-5, 17 CFR § 240.10b-5. This statute and regulation is produced in pertinent part in the Appendix to this petition (app. pp. 164-65).

STATEMENT OF THE CASE[1]

Petitioners Ivan and Joanne Schatz (the "Schatz") Plaintiffs below, sold controlling stock interests in their corporations to entrepreneur Mark E. Rosenberg's ("Rosenberg") holding company. The Schatz' sold their stock in exchange for a series of deferred payment promissory notes. The only real security in the deal was Rosenberg's personal guarantee of the notes. Rosenberg claimed to have a net worth of $7 million and gave the Schatz' a financial statement to that effect. The Schatz' sold their stock on the strength of the financial statement. The financial statement was phony. Within seven months, Rosenberg's flagship company was bankrupt. Rosenberg himself declared bankruptcy a little more than a year later. The Schatz' lost everything.

Rosenberg's attorney regarding the stock sale was the Baltimore law firm of Weinberg and Green. The

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[1] This case concerns dismissal of a Complaint under F. R. Civ. Pro. 12(b)(6). The foregoing facts are drawn from the allegations contained in Petitioners' Second Amended Complaint.

Schatz' discovered that Weinberg and Green had been well aware that their client, Rosenberg, was in financial hot water at the time that the sale closed. The Rosenberg $7 million financial statement was dated March 31, 1986. The deal closed December 31, 1986. Between March and December, Rosenberg went into financial free fall. This was mainly due to the financial problems of Rosenberg's "flagship" company, Yale Sportswear, Inc.

Weinberg and Green knew that Rosenberg was in financial free fall because they represented Rosenberg in July 1986 when he secured additional credit to help shore up Yale Sportswear, Inc. This additional credit totalled $3.2 million by December 8, 1986. Weinberg and Green also represented Rosenberg in another transaction that also closed on December 31, 1986 involving a nursing home management company whereby that company lost management contracts worth (by Rosenberg's own calculations) $1.25 million on his financial statement. Indeed, Weinberg and Green was general counsel to Rosenberg and all of his companies, including the floundering Yale Sportswear.

The law firm of Arent, Fox, Plotkin & Khan ("Arent, Fox") represented the Schatz' in the deal. Arent, Fox knew that Rosenberg's financial statement was dated March 31, 1986. Arent, Fox demanded that Rosenberg provide a new financial statement encompassing March-December transactions. Weinberg and Green said on behalf of Rosenberg that Rosenberg would provide an update letter stating that there had been no material adverse change in his financial status since the March 31, 1986 financial statement. The lawyers negotiated the language of the update letter

and the language to be used in the closing papers referencing the update letter.

The deal closed, with Weinberg and Green drafting the closing papers. At no time did Weinberg and Green tell the Schatz' about the financial transactions it had concluded on behalf of Rosenberg which materially adversely affected Rosenberg's March 31, 1986 financial statement. Nor did Weinberg and Green withdraw from closing the deal. The stock sale went forward, assets were stripped from the purchased businesses, and Rosenberg defaulted on the promissory notes.

The Schatz' commenced this litigation in the United States Bankruptcy Court for the District of Maryland against Rosenberg, MER Enterprises, Inc., a holding company controlled by Rosenberg, Stephen Jaeger (a former bank officer who became Rosenberg's advisor) and the law firm of Weinberg and Green. The Schatz' invoked the Bankruptcy Court's jurisdiction pursuant to 28 U.S.C. § 1334(b) and pursuant to 28 U.S.C. § 1331. Upon withdrawal of the reference, the case was transferred to the United States District Court for the District of Maryland from the Bankruptcy Court.

On January 24, 1990, the United States Magistrate recommended that the Complaint be dismissed as to Weinberg and Green pursuant to F. R. Civ. Pro. 12(b)(6) on the grounds that Weinberg and Green owed no duty to disclose their clients' fraud to the Schatz'. (app. pp. 51-135). On March 8, 1990, the District Court entered an order essentially to the same effect. (app. pp. 155-57). On October 15, 1990, the District Court denied a Motion for Reconsideration. (app. pp. 158-61). After settling with the remaining

defendants, the Schatz' filed a timely appeal to the United States Court of Appeals for the Fourth Circuit. The Fourth Circuit affirmed.

The Court of Appeals ruled in a broad opinion that attorneys owe no duties to disclose to third parties absent a fiduciary or similar relationship. The Fourth Circuit concluded that "unless a relationship of trust and confidence exists between a lawyer and a third party, the Federal Securities laws do not impose on a lawyer a duty to disclose information to a third party." 943 F.2d at 492. (app. pp. 22-23). Indeed, the Fourth Circuit stated that "attorney liability to third parties should not be expanded beyond liability for conflicts of interest." 943 F.2d at 493. (app. p. 28). After a timely Petition for Rehearing and Suggestion for Rehearing *En Banc* was denied on October 1, 1991 (app. pp. 162-63), the Plaintiffs timely filed this Petition for a Writ of Certiorari.

REASONS FOR GRANTING THE WRIT

This case presents the legal question of attorneys' duties to third parties under the Federal Securities laws. The Fourth Circuit's bright line "no duty" ruling raises serious and troubling issues. The Fourth Circuit's ruling effectively immunizes attorneys from liability to third parties even where attorneys knowingly assist their clients in perpetrating a fraud. Put another way, this case presents the question whether attorneys to a buyer of securities can be liable for knowingly assisting their client in documenting and closing a fraudulent deal where they knew the deal to be fraudulent.

I. THE RULING OF THE COURT OF APPEALS THAT ATTORNEYS WHO KNOWINGLY ASSIST THEIR CLIENTS IN THE PERPETRATION OF A FRAUD CANNOT BE FOUND LIABLE UNDER FEDERAL SECURITIES LAWS BECAUSE THEY OWE NO DUTY TO THIRD PARTIES IS WRONG AND CONTRARY TO THE DECISIONS OF AT LEAST TWO OTHER COURTS OF APPEALS.

In *Chiarella v. United States*, 445 U.S. 222 (1980), this Court held that silence, absent a duty to disclose, does not violate Section 10(b) and Rule 10(b)(5). In *Dirks v. S.E.C.*, 463 U.S. 646, 657-58 (1983), this Court reaffirmed that "a duty to disclose arises from the relationship between the parties" (Citing *Chiarella*). This case presents a similar issue not addressed in *Chiarella* or *Dirks*—the nature of an attorneys' duties to third parties regarding a stock sale documented by the attorneys.

The Court of Appeals held that an attorney is not under a duty to disclose fraud to a third party. The only time such a duty would arise, according to the Court of Appeals, would be if a relationship of trust or confidence exists or if an attorney affirmatively undertakes to give an opinion letter to an opposing party. The Court of Appeals specifically rejected finding a duty to disclose 1) arising from a law firm's affirmative participation in a deal known to be fraudulent, 2) in ethical requirements or 3) in public polity.

The Court of Appeals' holding is directly contrary to numerous district court cases which hold that attorneys can be liable to third parties for fraud, *i.e.*, *Boltz v. Flagship Partners Limited Partnership*, No. 89 C 9103 (N.D. Ill. Aug. 22, 1990) (complaint stated cause of action against law firm that drafted offering memorandum containing representations the firm

knew to be false); *In re: ZZZZ Best Securities Litigation*, No. CV 87-3574 RSWL (C.D. Cal. July 23, 1990) (attorneys violate Section 10(b) by drafting false prospectus and registration statement); *In re: Flight Transportation Corporations Securities Litigation*, 593 F. Supp. 612, 617-18 (D. Mn. 1984) (attorneys could be liable for preparing false or misleading prospectuses; duty arose from undertaking preparation of prospectuses); *Ahern v. Gaussoin*, 611 F. Supp. 1465, 1489 (D. Oregon 1985) (defendant attorneys could be liable for preparation of false prospectus and failure to update same); *Rose v. Arkansas Valley Environmental and Utility Authority*, 562 F. Supp. 1180, 1206 (W.D. Mo. 1983) (duty to disclose can arise from preparation of information to be distributed and relied on by third party).

The Court of Appeals' decision is also contrary to two recent Court of Appeals' decisions. The first is *Ikuno v. Yip*, 912 F.2d 306 (9th Cir. 1990). There the Ninth Circuit reversed a grant of summary judgment in favor of an attorney who represented a company which perpetrated a fraudulent commodity scheme. The attorney had incorporated the company and had filed two annual report forms. He had also negotiated a lease. This was enough to create an issue for the trier of fact regarding the attorney's civil RICO liability. Under the Court of Appeal's decision, the attorney in *Ikuno v. Yip*, would have had no liability since he would have owed no duties to defrauded third parties.

In a Securities Law context, the Court of Appeals' decision is contrary to *Breard v. Sachnoff & Weaver, Ltd*, 941 F.2d 142 (2d Cir. 1991). There, the Second Circuit found that attorneys for a Limited Partnership

had a duty to disclose adverse material facts to prospective limited partner investors in offering memoranda. The Fourth Circuit's broad "no duty" holding cannot be squared with *Breard.*

Finally, the Court of Appeals' decision is contrary to long-established *dicta* in numerous cases stemming from this Court's decision in *National Savings Bank v. Ward,* 100 U.S. 195, 205-06 (1879)("where there is fraud or collusion the [attorney] will be held liable even though there is no privity of contract"). *See* e.g. *Arthur Pew Construction Co., Inc. v. First Nat. Bank of Atlanta,* 827 F.2d 1488, 1493 (11th Cir. 1987) (same); *Allied Financial Services, Inc. v. Easley,* 676 F.2d 422, 423 (10th Cir. 1982) ("attorney owes a duty to his adversary not to engage in fraudulent or malicious conduct") (applying Colorado law); *Flaherty v. Weinberg,* 303 Md. 115, 492 A.2d 618, 620-21 (1985) (attorneys not primarily liable to nonclient third parties "absent fraud").

The Fourth Circuit's broad holding is without precedent. The Fourth Circuit relied upon a series of cases finding no duty to disclose notably, *Barker v. Henderson, Franklin, Starnes and Holt,* 797 F.2d 490 (7th Cir. 1986) and its progeny in the Seventh Circuit and *Abell v. Potomac Insurance Company,* 858 F.2d 1104 (5th Cir. 1988), *vacated on other grounds,* 492 U.S. 914 (1989) in the Fifth Circuit.

None of the cases relied upon by the Court of Appeals presented a case where attorneys were alleged to negotiate and knowingly draft false or fraudulent documents upon which opposing parties rely. *See Renovitch v. Kaufman,* 905 F.2d 1040 (7th Cir. 1990) (finding defendant attorneys had no duty to disclose where the attorneys had not prepared or authorized

the preparation of fraudulent brochures and had no communications with plaintiffs); *Barker v. Henderson, Franklin, Starnes and Holt, supra,* (upholding summary judgment in favor of defendant attorneys where the attorneys had not prepared or authorized the preparation of fraudulent brochures and had no communications with plaintiffs.)

District Courts within the Seventh Circuit, for example, have not applied *Barker* and its progeny to cases such as this one where attorneys knowingly negotiate and/or draft false or fraudulent documents. *See Renovitch v. Stewardship Concepts, Inc.*, 654 F. Supp. 353 (N.D. Ill. 1987) (distinguishing *Barker* at motion to dismiss stage); *Ferguson v. Lurie*, N. 89 C 2283 (N.D. Ill., October 31, 1990) (1990 W.L. 180582) (distinguishing *Barker* and denying motion to dismiss where Complaint alleged that lawyers had advised defendants in connection with a fraudulent deal and drafted fraudulent documents).

The Court of Appeals rejected the common-sense rule of law invoked by other courts, i.e. that an attorney's duty to disclose "arises from knowing assistance of or participation in a fraudulent scheme." *In re: U.S. Grant Hotel Association Limited Securities Litigation*, 740 F. Supp. 1460, 1464 (S.D. Ca. 1990)(Citing *Strong v. France*, 474 F.2d 747, 752 (9th Cir. 1973)). The rule of law to be applied on the facts alleged in this case presents an issue worthy of this Court's review.

II. THE RULING OF THE COURT OF APPEALS WRONGLY FINDS NO AIDING AND ABETTING LIABILITY

This Court has reserved ruling on whether Section 10(b) permits aiding and abetting liability. *Herman &*

MacLean v. Huddleston, 459 U.S. 375, 379 n. 5 (1983); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191-92 n. 7 (1976). That issue is presented here, where the law firm negotiated language in the closing documents and prepared closing documents, knowing that a fraud was being committed.

In that regard, the Court of Appeals established a "scrivener exception" to attorney liability. That is, the Court of Appeals held that where a law firm simply "papers" a deal initially negotiated by clients, the law firm cannot be held liable for misrepresentations made by the client in a financial disclosure statement, even on an aiding and abetting theory. *See* 943 F.2d at 497. (app. pp. 43-44). According to the Court of Appeals, actual knowledge that a fraud was being committed is apparently not enough. "[T]he lawyer must actively participate in soliciting sales or negotiating terms of the deal. . . ." 943 F.2d at 497. (app. p. 45).

The existence, nature and extent of the Court of Appeal's "scrivener exception" also warrants review. No other court has so squarely held. The District Court opinion relied upon by the Fourth Circuit, *Friedman v. Arizona World Nurseries, Ltd.*, 730 F. Supp 521 (S.D. NY 1990) does not stand for that proposition. In *Friedman*, the Court found no cause of action against attorney defendants where there were no facts pleaded as to why the attorneys knew that the offering memorandum prepared by the attorneys contained false and misleading information:

> There are no allegations that [the attorneys] had any specific communications or that they had met with any specific individuals which

> facts would have created the necessary strong inference that each of the attorney defendants have the requisite fraudulent intent". 730 F. Supp. at 534.

In this case, Weinberg and Green represented Rosenberg in connection with specifically identified adverse, material financial transactions during the time that Rosenberg's financial situation was crumbling. The lawyers were scriveners, but knowing scriveners—and negotiators of key language in the closing documents. The nature and extent of the law firm's aiding and abetting liability under these circumstances warrants review.

III. THE RULING OF THE COURT OF APPEALS INSULATING ATTORNEYS FROM KNOWING PERPETUATION OF FRAUD IN PREPARATION OF CLOSING DOCUMENTS IS WRONG AND WARRANTS REVIEW.

The decision of the Court of Appeals effectively immunizes attorneys from liability to third parties even where attorneys knowingly deal with the victims (or victims' counsel) and incorporate lies into closing documents. This runs directly counter to the purpose of and precedents under the Federal Securities Laws.

The Complaint filed in this case outlines a horror story for the defrauded sellers of stock. Had Weinberg and Green either disclosed the material adverse changes that they were aware of in their client's financial statement or, failing that, withdrawn from participating in the deal closing, the Schatz' would not have suffered as they did. Simply stated, the facts alleged in the Complaint amply stated a cause of action under Section 10(b). The Court of Appeals affirmance of the Summary Dismissal of the Complaint warrants review.

CONCLUSION

For the reasons stated herein, Petitioners respectfully request that this Court issue a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit.

Respectfully submitted,

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APPENDIX

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Ivan N SCHATZ; Joann B. Schatz,
Plaintiffs-Appellants,

v.

Mark E. ROSENBERG; MER Enterprises, Incorporated; Stephen Jaeger; Weinberg & Green, Defendants-Appellees.

No. 90-1889

United States Court of Appeals,
Fourth Circuit.

Argued May 8, 1991

Decided Aug. 26, 1991.

As Amended Oct. 9, 1991

Before WILKINSON, Circuit Judge, CHAPMAN, Senior Circuit Judge, and HILTON, District Judge for the Eastern District of Virginia, sitting by designation.

OPINION

CHAPMAN, Senior Circuit Judge

Plaintiffs/appellants Ivan and Joanne Schatz sued defendants Mark E. Rosenberg, MER Enterprises ("MER") and the law firm of Weinberg & Green alleging RICO violations, fraud and securities laws violations. The district judge referred the case to a magistrate judge who recommended that five counts of the seven count complaint be dismissed for failure to state a claim upon which relief can be granted. The district judge agreed and dismissed these five counts under Federal Rule of Civil Procedure 12(b)(6). Three of these counts involved Weinberg & Green. In this appeal, plaintiffs only challenge the dismissal of the three counts against Weinberg & Green.[1/]

[1/] Before oral argument, plaintiffs moved to amend the record on appeal to include (continued...)

I.

On December 31, 1986, MER purchased an eighty percent (80%) interest in two companies the plaintiffs owned, Virginia Adjustable Bed Manufacturing Corporation (VAMCO") and Advanced Bed Concepts ("ABC"). MER is a holding company which Mark Rosenberg created to purchase the VAMCO and ABC stock. As payment for their eighty percent (80%) interests in VAMCO and ABC, Mr. and Mrs. Schatz received $1.5 million in promissory notes issued by MER, which Rosenberg personally guaranteed. The plaintiffs relied on a financial statement

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[1](...continued)
the deposition of defendant Stephen Jaeger. This deposition was taken after the district judge dismissed the claims against Weinberg & Green. Initially, we granted the plaintiffs' motion; however, upon Weinberg & Green's motion for reconsideration, we now deny the motion to supplement the record. We must review the district judge's decision on the same record as that before the district court. However, we note that even the inclusion of Jaeger's deposition would not change the result, because it is not relevant to the legal sufficiency of the complaint.

dated March 31, 1986 and an update letter delivered at closing on December 31, 1986 which indicated that Rosenberg's net worth exceeded $7 million. These financial documents contained several misrepresentations obscuring the fact that Rosenberg's financial empire had crumbled between April and December of 1986. Rosenberg's largest business, Yale Sportswear Corporation ("Yale"), filed for bankruptcy in September 1987, and Rosenberg filed for personal bankruptcy thereafter. The law firm of Weinberg & Green represented Rosenberg and his entities throughout this periods.

The plaintiffs never received payment on their promissory notes and lost an additional $150,000 when they made a "bridge loan" to BBC, the company which was formed when VAMCO and ABC merged with the Back Center, Inc. ("BCI"), another of Rosenberg's companies. To add insult to

injury, Rosenberg paid Weinberg & Green's legal fees for the transaction out of VAMCO and ABC's cash reserves. Rosenberg siphoned off operating capital from VAMCO and ABC to prop up Yale. By the time Rosenberg and Yale filed for bankruptcy, VAMCO and ABC were essentially worthless, and plaintiffs had no control over the businesses. Thereafter, plaintiffs filed a seven-count complaint asserting: a violation of the Racketeer Influence and Corrupt Organizations Act ("RICO") against defendants Rosenberg and Jaeger (Count I), violations of section 10(b) of the Securities Exchange Act of 1934 against Rosenberg and Jaeger (Count II), and Weinberg and Green (Count III), violations of section 12 of the Securities Act of 1933 against Rosenberg and MER (Count IV), common law fraud against Rosenberg and Jaeger (Count V), aiding and abetting liability under the securities laws against

Weinberg & Green (Count VI), common law misrepresentation against Weinberg & Green (Count VII), and declaration of non-dischargeability in bankruptcy of debts owed by Rosenberg (Count VIII).

In response to the complaint, the defendants filed motions to dismiss. Before the district judge ruled on these motions, the Schatzes filed an amended complaint on July 29, 1988. The defendants again filed motions to dismiss, and before the district judge ruled on the second round of motions, the Schatzes filed a second amended complaint, which added several factual allegations in support of the claims. The defendants then filed a third set of motions, which the district judge referred to a federal magistrate judge, who issued her report on March 8, 1990. She recommended that count III against Weinberg & Green, which alleges primary liability under section 10(b) of

the Securities Act of 1934, be dismissed without prejudice. The magistrate judge reasoned that plaintiffs could not recover under this cause of action because they did not allege a relationship with Weinberg & Green that would give rise to an independent duty to disclose to them nor did they allege that the law firm made any affirmative misrepresentation.

Similarly, she recommended that plaintiffs' securities claims charging Weinberg & Green with aider and abettor liability be dismissed, and found that "nowhere, in the many pages of opposition, do plaintiffs even hint at what Weinberg & Green did to cause Rosenberg to commit fraud." Finally, she found that plaintiffs' third claim against Weinberg & Green for misrepresentation under Maryland state law was deficient for the same reason as their claim for liability under section 10(b): absent a duty to disclose, mere

silence or failure to disclose material facts do not constitute fraud under Maryland law.

On March 8, 1990, the district judge issued an opinion in which he accepted the recommendations to dismiss the counts against Weinberg & Green, but rejected the recommendation that plaintiffs be granted leave to amend these counts. Although the district judge noted that leave to amend should usually be freely granted, he concluded that since plaintiffs had amended the complaint twice, they did not deserve another opportunity to cure their defective pleadings. The judge noted that the plaintiffs never claimed that they could allege that Weinberg & Green had made any affirmative misstatements or other misrepresentations. Therefore, he doubted whether plaintiffs could ever plead a viable cause of action against these defendants.

On September 12, 1990, the Schatzes moved for reconsideration based on an opinion they had obtained from the Maryland State Bar Association's Committee on Ethics. The district court denied this motion, and the Schatzes appeal.

II.

We review de novo a district court's decision to dismiss a complaint for failure to state a claim under Federal Rule of Civil Procedure 12(b)(6). Korb v. Lehman, 919 F. 2d 243, 246 (4th Cir. 1990). In reviewing the legal sufficiency of the complaint, we construe the factual allegations "in the light most favorable to plaintiff." Battlefield Builders, Inc. v. Swango, 743 F.2d 1060, 1062 (4th Cir. 1984). However, we are "not so bound with respect to [the complaint's] legal conclusions. Were it otherwise, Rule 12 (b)(6) would serve no function, for its purpose is to provide a defendant with a

mechanism for testing the legal sufficiency of the complaint." District 28, United Mine Workers, Inc. v. Wellmore Coal Corp., 609 F.2d 1083, 1085-86 (4th Cir. 1979). Accordingly, we will affirm a dismissal for failure to state a claim if it appears that the plaintiffs would not be entitled to relief under any facts which could be proved in support of their claim.

III.

Plaintiffs argue that Weinberg & Green committed fraud by remaining silent even though it knew that its client, Rosenberg, was financially insolvent. Plaintiffs allege in their second amended complaint that:

-Weinberg & Green provided legal services to Rosenberg in the past and in connection to the purchase of plaintiffs' business;

-Weinberg & Green had a copy of Rosenberg's financial statement, which it

knew to be false as a result of legal services to Rosenberg and his various companies;

-Weinberg & Green prepared draft closing documents for the purchase of plaintiffs' business, which Weinberg & Green then delivered to plaintiffs' lawyers;

-Weinberg & Green gave plaintiffs a letter from Rosenberg at closing in which Rosenberg stated that no material adverse changes had occurred in his financial condition; and

-Weinberg & Green and plaintiffs' lawyers jointly agreed on language in the purchase agreement stating that Rosenberg had delivered his 1986 financial statement and an update letter to the plaintiffs, and that the letters were accurate in all material respects.

Based on the facts, plaintiffs argue that Weinberg & Green is liable (1) for

violating section 10(b) of the 1934 Securities Act, (2) for aiding and abetting a violation of the securities laws, and (3) for knowingly perpetrating or assisting in misrepresentations under Maryland tort law.

A. Section 10(b) and Rule 10b-5

To state a claim for a primary violation of section 10(b) and Rule 10b-5, a plaintiff must allege that the defendant (1) made an untrue statement of material fact or omitted a material fact that rendered the statements misleading, (2) in connection with the purchase or sale of a security, (3) with scienter, and (4) which caused plaintiff's losses. Schlifke v. Seafirst Corp., 866 F.2d 935, 943 (7th Cir. 1989). Plaintiffs claim that Weinberg & Green violated section 10(b) and Rule 10b-5 by failing to disclose Rosenberg's misrepresentations and by making affirmative misrepresentations about Rosenberg's financial condition.

1. Weinberg & Green's Nondisclosure of Rosenberg's Misrepresentations

We first address whether Weinberg & Green's failure to disclose Rosenberg's misrepresentations to the Schatzes subjects the law firm to liability under section 10(b) and Rule 10b-5. Silence, absent a duty to disclose, does not violate section 10(b) and Rule 10b-5. Chiarella v. United States, 445 U.S. 222, 228, 100 S. Ct. 1108, 1114, 63 L.Ed.2d 348 (1980); accord Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 496 (7th Cir. 1986) (When the claimed violation arises not from a misstatement, but from a "failure to blow the whistle," liability will not attach unless the defendant has "a duty to blow the whistle."). Plaintiffs argue that Weinberg & Green had a duty to disclose Rosenberg's misrepresentations on the basis of federal securities cases, Maryland common law, and the Maryland Code of Professional Responsibility. In addition,

plaintiffs argue that as a matter of public policy, lawyers should have a duty to disclose a client's fraudulent activity to a third party. We review these claims seriatim.

a. Duty to Disclose Based on Federal Securities Laws

We first address whether the federal securities laws impose upon an attorney a duty of disclosure to third parties who are not the attorney's clients. The Supreme Court has decreed that under the federal securities laws, a duty to disclose "arises from the relationship between parties," Dirks v. SEC, 463 U.S. 646, 658, 103 S. Ct. 3255, 3263, 77 L.Ed2d 911 (1983), and will exist if there is "a fiduciary or other similar relation of trust and confidence between them." Chiarella, 445 U.S. at 228, 100 S. Ct. at 1114. Thus, the Supreme Court has established the type of relationship which will create a duty of disclosure. The Court has never determined

whether, under circumstances other than fiduciary relationships, the securities laws impose a duty of disclosure to third parties. Plaintiffs urge us to adopt the approach of several federal district courts which have held that a law firm can be liable for misrepresentation under section 10(b) if it disseminates false information "with an intent, knowledge or awareness that the intent, knowledge or awareness that the information will be communicated or disseminated to persons...in connection with the purchase or sale of a security." Rose v. Arkansas Valley Envtl & Util. Author., 562 F. Supp. 1180, 1206 (W.D.Mo. 1983). We decline this invitation and hold that a lawyer or law firm cannot be held liable for misrepresentation under section 10(b) for failing to disclose information about a client to a third party absent some fiduciary or other confidential relationship with the third party. See

<u>Barker v. Henderson, Franklin, Starnes & Holt</u>, 797 F.2d 490, 496 (7th Cir. 1986) (Because neither section 10(b) nor Rule 10b-5 imposes a duty to disclose, any such duty "must come from a fiduciary relation outside securities law.").

Facing this identical issue, the Seventh Circuit has ruled that lawyers have no duty to disclose information about clients to third party purchasers or investors in the absence of a confidential relationship between the attorney and the third party.[2/]

[2/] The Seventh Circuit has also consistently applied this rule to accountants who do not disclose damaging financial information about a client to a potential third party investor or purchaser. <u>See, e.g., DiLeo v. Ernst & Young</u>, 901 F.2d 624 (7th Cir.) (accountant under no legal duty to blow whistle on client upon discovery that client in financial trouble), <u>cert. denied</u>, --U.S.--,111 S. Ct. 347, 112 L.Ed.2d 312 (1990); <u>Latigo Ventures v. Laventhol & Horwath</u>, 876 F.2d 1322, 1327 (7th Cir. 1989) (accountant has no duty to blow whistle on client in order to protect investors); <u>LHLC Corp. v. Cluett, Peabody</u>
(continued...)

In Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 4390 (7th Cir. 1986), the Seventh Circuit considered whether a law firm had a duty to disclose information relevant to its clients' financial stability to third party investors. The court determined that unless the law firm had some fiduciary relationship with the third party, it had no duty of disclosure: "Neither lawyers nor accountants are

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[2](...continued) & Co., 842 F.2d 928, 933 (7th Cir.) (accountant under no duty to disclose client's fraud to potential investor), cert. denied, 488 U.S. 926, 109 S. Ct. 311, 102 L.Ed.2d 329 (1988). Other federal courts have agreed with the Seventh Circuit. See, e.g., Windon Third Oil & Gas Drilling Partnership v. Federal Deposit Ins. Corp., 805 F.2d 342, 347 (10th Cir. 1986) (absent fiduciary relationship, accountant had no duty to disclose information about corporation's financial condition during discussions with potential investor), cert. denied, 480 U.S. 947, 107 S. Ct. 1605, 94 L.Ed.2d 791 (1987); Leoni v. Rogers, 719 F.Supp. 555, 556 (E.D. Mich. 1989) (accounting firm owed no duty of disclosure to potential investor of client as long as accountant had no fiduciary relationship with investor).

required to tattle on their clients in the absence of some duty to disclose. To the contrary, attorneys have privileges not to disclose." Id. at 497 (citations omitted). Accord Renovitch v. Kaufman, 905 F.2d 1040 (7th Cir. 1990) (outside of a fiduciary duty to a third party investor, law firm has no duty to disclose financial information about client to the investor); First Interstate Bank v. Chapman & Cutler, 837 F.2d 775, 780 n. 4 (7th Cir. 1988) (bond counsel not liable to bond purchaser for false opinion letter which was based on purportedly false assumption).

Likewise, the Fifth Circuit has determined that absent a fiduciary or other confidential relationship, lawyers have no duty to disclose information about clients to third party investors. In Abell v. Potomac Ins. Co., 858 F.2d 1104 (5th Cir. 1988), vacated on other grounds, 492 U.S. 914, 109 S.Ct.3236, 106 L.Ed.2d 584 (1989),

the Fifth Circuit held that an underwriter's counsel owed bondholders no duty to disclose inaccuracies in an offering statement for the bonds, even though counsel had a duty of "due diligence" to investigate the representations in the statement and even though counsel permitted its name to appear on the cover of the offering statement. The court explained that

> the law, as a general rule, only rarely allows third parties to maintain a cause of action against lawyers for the insufficiency of their legal opinions. In general, the law recognizes such suits only if the non-client plaintiff can prove that the attorney prepared specific legal documents that represent explicitly the legal opinion of the attorney preparing them, for the benefit of the plaintiff.
>
> In practice, this rule has meant that an attorney is rarely liable to any third party for his or her legal work unless the attorney has prepared a signed "opinion" letter designed for the use of a third party.

Id. at 1124-25 (citations and footnote omitted). Based on this reasoning, the court determined that the underwriter's counsel should not be liable to third parties for failing to disclose misrepresentations in the offering circular.

In addition to these circuits, other federal courts have come to the same conclusion. See, e.g., Bush v. Rewald, 619 F.Supp. 585 (D.Haw. 1985) (lawyer owed no duty to investors buying from organization when organization, not investors, was attorney's client); Quintel Corp. v. Citibank, 589 F.Supp. 1235 (S.D.N.Y.1984) (counsel to partnership owed no duty of disclosure to limited partners).

Plaintiffs rely on several federal securities cases which have held attorneys liable under section 10(b) for failing to disclose misrepresentations made by clients to third parties. First, plaintiffs cite

cases imposing liability on attorneys for issuing a reckless and misleading bond opinion letter. See T.J. Raney & Sons, Inc. v. Fort Cobb, Okl. Irr. Fuel Author., 717 F.2d 1330 (10th Cir.1983), cert. denied, 4365 U.S. 1026, 104 S.CT. 1285, 79 L.Ed.2d 687 (1984); Cronin v. Midwestern Okl. Develop. Author., 619 F.2d 856, 862 (10th Cir. 1980). However, these cases are clearly distinguishable because they involve lawyers who issued misleading legal opinions. In this case, however, plaintiffs do not claim that Weinberg & Green made inaccurate legal representations, only that they failed to tattle on their client for misrepresenting his personal financial condition.

Plaintiffs also cite cases in which courts imposed liability on attorneys who drafted false prospectuses or other securities documents. See Renovitch v. Stewardship Concepts, Inc., 654 F.Supp.

353, 359 (N.D. Ill. 1987); _In re Flight Transportation Corp. Sec. Lit._, 593 F.Supp. 612, 617-18 (D.Minn. 1984); _Blakely v. Lisac_, 357 F.Supp. 255, 266-67 (D.Or. 1972). These cases, however, are also easily distinguished because they involve affirmative misrepresentations made in the solicitation of securities. In our case, Weinberg & Green did not solicit any purchase of securities or prepare any solicitation documents. In fact, Rosenberg and the Schatzes worked out the details of the purchase of the business before involving the attorneys for either side. Accordingly, none of these authorities persuade us to adopt a rule contrary to the rule adopted by the Fifth and Seventh Circuits. We hold that unless a relationship of "trust and confidence" exists between a lawyer and a third party, the federal securities laws do not impose

on a lawyer a duty to disclose information to a third party.

b. Duty of Disclosure based on <u>Maryland Law</u>

Plaintiffs also claim that the Maryland Rules of Professional Conduct obligated Weinberg & Green to either withdraw from representing Rosenberg or to disclose his financial misrepresentations to the plaintiffs. In support of this claim, plaintiffs' counsel submitted to the Maryland State Bar Committee on Ethics an anonymous request for an ethics ruling on the facts of the present case. The committee concluded that a law firm in Weinberg & Green's position had an ethical duty to either withdraw from representation or disclose the misrepresentations to the third person. This ethical responsibility, plaintiffs argue, establishes a legal duty to disclose and subjects Weinberg & Green to section 10(b) liability.

We reject this argument. An ethical duty of disclosure does not create a corresponding legal duty under the federal securities laws. Courts have consistently refused to use ethical codes to define standards of civil liability for lawyers. See, e.g., Bickel v. Mackie, 447 F.Supp. 1376, 1383-84 (N.D.Iowa), aff'd mem. 590 F.2d 341 (8th Cir. 1978); Merritt-Chapman & Scott Corp. v. Elgin Coal, Inc., 358 F.Supp. 17, 22 (E.D. Tenn. 1972), aff'd mem., 477 F.2d 598 (6th Cir. 1973). More specifically, courts have refused to base a legal duty of disclosure for section 10(b) on a disciplinary rule. In Tew v. Arky, Freed, Sterns, Watson, Greer, Weaver, & Harris, P.A., 655 F.Supp. 1573 (S.D. Fla. 1987), aff'd mem., 846 F.2d 753 (11th Cir.), cert. denied, 488 U.S. 854, 109 S.Ct. 142, 102 L.Ed.2d 114 (1988), the court held that violation of a disciplinary rule did not create a legal duty requiring

a law firm to disclose information it had learned in a prior business meeting to a client's auditors.

The rationale for these rulings is clear. The ethical rules were intended by their drafters to regulate the conduct of the profession, not to create actionable duties in favor of third parties. The preliminary statement to the Model Code, upon which the Maryland code is patterned, warns that the Code does not "undertake to define standards for civil liability of lawyers for professional conduct." Preliminary Statement, Model Code of Professional Responsibility. We believe this statement accurately reflects the goals and purposes of the Maryland Code of Professional Responsibility. Thus, we hold that the ethical rules do not create a legal duty of disclosure on lawyers and that plaintiffs cannot base a securities

fraud or other misrepresentation claim on a violation of an ethical rule.

We also hold that Maryland common law does not impose a duty to disclose under these circumstances. In the negligence context, Maryland courts have held that a lawyer only owes a duty to his clients or third party beneficiaries of the attorney-client relationship. See Flaherty v. Weinberg, 303 Md. 116, 492 A.2d 618 (1985). Applying such rule to the facts of this case, we hold that because plaintiffs were neither clients nor third party beneficiaries of the attorney-client relationship, Weinberg & Green had no duty to disclose.

Plaintiffs rely on Crest Investment Trust, Inc. v. Comstock, 23 Md. App. 280, 327 A.2d 891 (1974), to establish a common law duty of disclosure for lawyers. However, this case says nothing about whether an attorney owes a duty of

disclosure to persons who are not his clients. Comstock involved a lawyer who had a conflict of interest use he tried to represent both sides in a transaction, and, therefore, the lawyer owed a duty of disclosure to both sides. Thus, Comstock does not impose a duty of disclosure on a lawyer to a third party the lawyer does not represent. In this case, plaintiffs do not allege that Weinberg & Green represented them; in fact, plaintiffs admit that they were represented by their own chosen lawyers. Thus, the facts of Comstock are not analogous to this case.

c. Duty of Disclosure Based on Public Policy

Precedent aside, plaintiffs also argue that, as a matter of public policy, lawyers should not be permitted to perpetrate or assist in a fraud without being held responsible for their wrongdoing. Plaintiffs' counsel urges the court to rule that a lawyer has a duty to disclose

misrepresentations to innocent third parties on the basis of public policy. While we sympathize with plaintiff's position and certainly do not condone lawyers making misrepresentations, we find that public policy counsels against imposing such a duty. Attorney liability to third parties should not be expanded beyond liability for conflicts of interest. See Flaherty, 492 A.2d at 626. Any other result may prevent a client from reposing complete trust in his lawyer for fear that he might reveal a fact which would trigger the lawyer's duty to the third party. Similarly, if attorneys had a duty to disclose information to third parties, attorneys would have an incentive not to press clients for information. The net result would not be less securities fraud. Instead, attorneys would more often be unwitting accomplices to the fraud as a result of being kept in the dark by their

clients or by their own reluctance to obtain information. The better rule -- that attorneys have no duty to "blow the whistle" on their clients -- allows clients to repose complete trust in their lawyers. Under those circumstances, the client is more likely to disclose damaging or problematic information, and the lawyer will more likely be able to counsel his client against misconduct.

Other federal courts have arrived at similar conclusions in addressing the policy concerns of this identical issue. The Fifth Circuit explained that

> It is well understood in the legal community that any significant increase in attorney liability to third parties could have a dramatic effect upon our entire system of legal ethics. An attorney required by law to disclose "material facts' to third parties might thus breach his or her duty, required by good ethical standards, to keep attorney-client confidences. Similarly, an attorney required to declare publicly his or her legal opinion of a client's actions and statements may find it impossible to remain as loyal to the

> client as legal ethics properly require.

<u>Abell v. Potomac Ins. Co.</u>, 858 F.2d 1104, 1124 (5th Cir. 1988), <u>vacated on other grounds</u>, 492 U.S. 914, 109 S.Ct. 3236, 106 L.Ed.2d 584 (189) (footnotes omitted).

Likewise, the Seventh Circuit, in the accounting context, refused to impose a duty of disclosure based upon policy reasons:

> Such a duty would prevent the client from reposing in the accountant the trust that is essential to an accurate audit. Firms would withhold documents, allow auditors to see but not copy, and otherwise emulate the CIA, if they feared that access might lead to destructive disclosure -- for even an honest firm may fear that one of its accountant's many auditors would misunderstand the situation and ring the tocsin needlessly, with great loss to the firm.

<u>DiLeo v. Ernst & Young</u>, 901 F.2d 624, 629 (7th Cir.), <u>cert. denied</u>, --- U.S. ---, 111 S.Ct. 347, 112 L.Ed.2d 312 (1990) (accountant under no legal duty to blow whistle on client upon discovery that client was in financial trouble).

Therefore, we hold that public policy interests protected by the attorney-client relationship outweigh any public policy interests served by imposing a duty of disclosure like the one urged by the plaintiffs in this case.

2. Affirmative Misrepresentations by Weinberg & Green

Plaintiffs also claim that Weinberg & Green violated section 10(b) by making various affirmative misstatements. Plaintiffs complain that Weinberg & Green informed plaintiffs' attorney that it would supply an update letter which would state that Rosenberg's financial position had not materially changed as of December 31, 1986. Weinberg & Green then presented the update letter to plaintiffs' counsel. The letter misrepresented Rosenberg's financial position, and the agreement and closing documents drafted by Weinberg & Green contained representations made by Rosenberg that the financial statement was "true,

correct, and complete in all material respects."

Plaintiffs never contend that Weinberg & Green made any representations other than those made by Rosenberg. In fact, plaintiffs only claim that Weinberg & Green stated that Rosenberg would supply an update letter and that Weinberg & Green forwarded the Rosenberg letter to plaintiffs' attorneys. Since Weinberg & Green made no independent affirmative misstatements, Weinberg & Green did not commit a primary violation of section 10(b) See Friedman v. Arizona World Nurseries, Ltd., 730 F.Supp. 521 (S.D.N.Y. 1990) (lawyers who drafted an offering which included an offering memorandum, a legal opinion, and a tax assistance letter not liable for misrepresentations in the offering memorandum since it was not a representation from the law firm). Weinberg & Green's drafting of closing

documents which contained representations by Rosenberg does not mean that they warranted or promised that Rosenberg had been honest.[3]

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[3] Plaintiffs argue that Bonavire v. Wampler, 779 F.2d 1011, 1014-15 (4th Cir. 1985) requires that Weinberg & Green be held liable for misrepresentation. In Wampler, we affirmed a jury verdict finding an attorney liable for misrepresentation that a promoter was an "honest straightforward businessman." However, the facts of Wampler differ significantly from the facts of this case. In Wampler, the attorney himself made personal affirmative representations about the promoter. Moreover, the attorney was actually involved in the deal. First the attorney acted as the escrow agent for the parties, thereby creating a potential conflict of interest. Second, the attorney made affirmative representations to the plaintiffs regarding personal and business information about the defendants. In our case, however, Weinberg & Green only "papered the deal," and did not participate in negotiation or solicitation as did the attorneys in Wampler. In fact, Rosenberg and the Schatzes worked out the details before consulting with their respective attorneys. Second, Weinberg & Green did not make any affirmative representations about Rosenberg to plaintiffs; rather the law firm only put Rosenberg's representations to paper. Finally, the plaintiffs in Wampler clearly relied upon the affirmative representations of the attorney in closing the deal; in our case,
(continued...)

Plaintiffs also argue that Weinberg & Green should be liable for the affirmative misrepresentations that Rosenberg made under principles of agency law. See Restatement (Second) of Agency § 348 ("[a]n agent who fraudulently makes representations, . . . or knowingly assists in the commission of tortious fraud . . . by his principal . . . is subject to liability in tort to the injured person although the fraud or duress occurs in a transaction on behalf of the principal."). Plaintiffs apparently believe that, under general principles of agency law, whenever a lawyer incorporates a representation by a client into a letter, contract, or other document, the representation becomes the lawyer's as well as the client's. This argument inherently presents two issues:

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[3](...continued) plaintiffs relied upon Rosenberg's representations which Weinberg & Green had put on paper.

first, as a matter of law, whether an attorney-client relationship should be treated as a typical agent-principal relationship governed by the general laws of agency; and second, as a matter of fact, whether Weinberg & Green "knowingly assisted" Rosenberg in his fraud in its status as his agent as required by the Restatement section. We are reviewing only the legal sufficiency of the complaint, we, therefore, will only consider the first issue which requires a ruling of law.

There are numerous similarities between an attorney-client relationship and an agent-principal relationship, and a lawyer may act as an agent for a client in various financial transactions, such as when the lawyer negotiates the terms of the transaction for the client. However, the fact that an attorney is an agent in that he represents his client does not automatically make the attorney liable

under agency law for misrepresentations his client makes. Regardless of what plaintiffs wish the law required of lawyers, lawyers do not vouch for the probity of their clients when they draft documents reflecting their clients' promises, statements, or warranties. Thus, Weinberg & Green's alleged transmission of Rosenberg's misrepresentations does not transform those misrepresentations into the representations of Weinberg & Green.

In Friedman v. Arizona World Nurseries, Ltd., 730 F.Supp. 521 (S.D.N.Y. 1990), the court considered whether to dismiss a complaint under Section 10(b) and Rule 10b-5 against a law firm that drafted an offering memorandum and a legal opinion and tax assistance letter included in the memorandum. The court determined that, with respect to "the only parts of the memorandum which arguably contain representations from [the law firm] to the

limited partners" -- the legal opinion and the tax assistance letter -- plaintiffs failed to identify any misrepresentations. Id. at 533-34. As for the remainder of the offering memorandum, the court declared that "counsel who merely draft [an offering memorandum] cannot be held liable for the general statements in the offering memorandum not specifically attributed to them." Id. at 533.

We find this reasoning persuasive[4] and therefore hold that a lawyer or law firm cannot be liable for the representations of a client, even if the lawyer incorporates the client's misrepresentations into legal

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[4] The two cases that plaintiffs rely upon to support their "agency law" theory are inapposite. In neither case did the court impose liability on an attorney who drafted legal documents containing his client's representations and for his clients's signature. See Bechtel v. Liberty National Bank, 534 F.2d 1335, 1339 n. 6 (9th Cir. 1976) (holding banker liable for misrepresentations made as agent); Hager v. Mobley, 638 P.2d 127 (Wyo. 1981)(holding realtor liable for misrepresentations made as an agent).

documents or agreements necessary for closing the transaction. In this case, Weinberg & Green merely "papered the deal," that is, put into writing the terms on which the Schatzes and Rosenberg agreed and prepared the documents necessary for closing the transactions. Thus, Weinberg & Green performed the role of a scrivener. Under these circumstances, a law firm cannot be held liable for misrepresentations made by a client in a financial disclosure statement.

B. Liability for aiding and abetting a violation of the securities laws

Plaintiffs make claims for aider and abettor liability under sections 12(2) and 10(b) of the 1934 Securities Act. Both causes of action require the plaintiff to prove the following three elements to establish an aiding and abetting securities violation: (1) a primary violation by another person; (2) the aider and abettor's "knowledge" of the primary violation; and

(3) substantial assistance by the aider and abettor in the achievement or consummation of the primary violation. Bloor v. Carro, Spanbock, Londin, Rodman & Fass, 754 F.2d 57, 62 (2d Cir. 1985); Martin v. Pepsi-Cola Bottling Co., 639 F.Supp. 931, 934-35 (D.Md. 1986); In re Action Industries Tender Offer, 572 F.Supp. 846, 853 (E.D.Va. 1983). Without deciding whether the plaintiffs have adequately plead a primary violation by Rosenberg, we hold that the plaintiffs have not alleged facts establishing that Weinberg & Green possessed the requisite "knowledge" of a securities violation or that Weinberg & Green "substantially assisted" a securities violation. Thus, plaintiffs' aiding and abetting claims fail.[5]

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[5] Because we hold that Weinberg & Green did not substantially assist Rosenberg in his fraudulent activity, plaintiffs cannot assert an aider and abettor claim under section 12(2) or 10(b). Accordingly, we do not decide whether the (continued...)

1. Scienter

First, we address plaintiffs' allegation that Weinberg & Green possessed the requisite "knowledge" or scienter of a securities violation required for aider and abettor liability. In their complaint, the

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[5](...continued) fact that plaintiffs are not "statutory sellers" would prevent them from asserting a claim under section 12(2). In Pinter v. Dahl, 486 U.S. 622, 108 S.Ct. 2063, 100 L.Ed.2d 658 (1988), the Supreme Court held that section 12(1) can only be applied to statutory sellers, i.e., those who actually solicit securities purchases. Although the Court expressly reserved the question of aider and abettor liability under section 12(2) for non-statutory sellers, see id. at 648-49 n. 24, 108 S.Ct. at 2079 n. 24, several lower courts have extended Dahl to limit aider and abettor liability under section 12(2) to statutory sellers of securities as well. See, e.g., In re Craftmatic Sec. Litig. v. Kraftsow, 890 F.2d 628 (3d Cir. 1989); Wilson v. Saintine Exploration & Drilling Corp., 872 F.2d 1124 (2d Cir. 1989). We have not previously decided whether, in light of Pinter, aider and abettor liability under section 12(2) should be limited to statutory sellers. See Baker, Watts & Co. v. Miles & Stockbridge, 876 F.2d 1101, 1106 n. 3 (4th Cir. 1989) (citing Pinter and Wilson, but not deciding whether law firm was "seller" under section 12(2) so as to be liable for aider and abettor liability).

Schatzes allege that Weinberg & Green "knowingly and/or recklessly provided substantial assistance" to the fraud. This allegation, argue the plaintiffs, meets the scienter requirement and adequately states a cause of action for aider and abettor liability. However, an evaluation of the "knowledge" requirement of the aiding and abetting liability test turns upon whether the aider and abettor defendant owed a duty to the plaintiff. When there is no duty running from the alleged aider and abettor to the plaintiff, the defendant must possess a "high conscious intent" and a "conscious and specific motivation" to aid the fraud. See Itt, an Internat'l Invest. Trust v. Cornfeld, 619 F.2d 909, 925 (2d Cir. 1980); Woodward v. Metro Bank of Dallas, 522 F.2d 84, 97 (5th Cir. 1975); Martin v. Pepsi-Cola Bottling Co., 639 F.Supp. 931, 934-35 (D.Md. 1986).

We have already held that Weinberg & Green had no duty of disclosure, arising under either the federal securities laws or Maryland state law, to inform the Schatzes that Rosenberg's financial status had changed. Accordingly, plaintiffs must allege that Weinberg & Green had a "conscious and specific motivation" to aid and abet the fraud to state a cause of action for aider and abettor liability. Plaintiffs have not, and in the opinion of the district judge, could not allege such a level of scienter. Therefore, the complaint fails to state a cause of action against Weinberg & Green for aider and abettor liability.

2. <u>Substantial Assistance</u>

We also hold that plaintiffs have not pled an aider and abettor claim, because plaintiffs have not adequately alleged that Weinberg & Green "substantially assisted" Rosenberg in the fraud. Plaintiffs claim

that Weinberg & Green "substantially assisted" Rosenberg's fraudulent activity in two ways: first, Weinberg & Green substantially assisted the fraud by failing "to either disclose or correct the misrepresentations or to withdraw from the representation of Rosenberg and/or MER" and second, Weinberg & Green substantially assisted the fraud by "participating in negotiations, drafting documents and conducting the Closing of its offices."

We first address whether Weinberg & Green can be liable for aider and abettor liability for failing to disclose Rosenberg's misrepresentations to the Schatzes. Absent a duty to disclose, allegations that a defendant knew of the wrongdoing and did not act fail to state an aiding and abetting claim. See In re Gas Reclamation, Inc. Sec. Lit., 659 F.Supp. 493 (S.D.N.Y. 1987) (allegations that defendant accounting firm knew of alleged

fraud and failed to disclose it or otherwise stop scheme failed to state an aiding-abetting claim); Quintel Corp. v. Citibank, 589 F.Supp. 1235 (S.D.N.Y. 1984) (allegations that attorney remained silent to aid his client's fraud did not adequately plead an aider and abettor claim because complaint never alleged that attorney "had a direct involvement in the transaction or deliberately covered up the fraud"). We have already held that Weinberg & Green owed no duty to disclose Rosenberg's misrepresentations to the Schatzes; thus, Weinberg & Green cannot be held liable as aiders and abettors for failing to disclose this information.

The plaintiffs also allege that Weinberg & Green provided substantial assistance to Rosenberg by representing him in the transaction. They argue that a lawyer provides "substantial assistance" in aiding and abetting tortious conduct if he

prepares or disseminates documents containing material misrepresentations or omissions. However, the "substantial assistance" element requires that a lawyer be more than a scrivener for a client; the lawyer must actively participate in soliciting sales or negotiating terms of the deal on behalf of a client to have "substantially assisted" a securities violation. In other words, a plaintiff must prove that a defendant rendered "substantial assistance" to the primary securities law violation, not merely to the person committing the violation.

If a lawyer, for example, is a member of the investment group, acts as a general agent for the investment group and not merely its attorney, or actively participates in the transaction by inducing or soliciting sales or by negotiating terms of the deal, the lawyer may be held liable for substantially assisting a securities

violation. However, when a lawyer offers no legal opinions or affirmative misrepresentations to the potential investors and merely acts as scrivener for the investment group, the lawyer cannot be liable as a matter of law for aider and abettor liability under the securities laws without an allegation of a conscious intent to violate the securities laws. See Woodward v. Metro Bank of Dallas, 522 F.2d 84, 96 (5th Cir. 1975) (when "transactions constitut[e] the daily grist of the mill," courts are "loathe to find 10b-5 liability without clear proof of intent to violate the securities laws"); see also Stokes v. Lokken, 644 F.2d 779, 784 (8th Cir. 1981) (attorney's tangential involvement in securities transaction insufficient for aiding and abetting claim).

In this case, Weinberg & Green did no more than "paper the deal" or act as a scrivener for Rosenberg. These activities

cannot form the basis for a securities violation since plaintiffs never allege any facts tending to show an intent on Weinberg & Green's part to violate the securities laws. While it is true that some of Rosenberg's documents prepared by Weinberg & Green (on the basis of information provided by Rosenberg) were misleading, this fact alone does not meet the "substantial assistance" threshold. Otherwise, there would be a per se rule holding attorneys liable in every securities fraud case, because in virtually every transaction, attorneys draft the closing documents. Clearly, the fact that an attorney drafts a closing document does not automatically create a warranty that every statement and agreement made by the client is true. Any other result would make attorneys co-guarantors and co-signatories, along with their clients, in every securities transaction.

C. Liability for knowingly or recklessly perpetuating a misrepresentation under Maryland tort law

Count VII of the plaintiffs' complaint purports to state a cause of action for common law misrepresentation under Maryland law. Under Maryland law, concealment of material facts renders a party liable for fraud. Parish v. Maryland & Virginia Milk Producers Ass'n., 250 Md. 24, 242 A.2d 512, 539 (1968), cert. denied, 404 U.S. 940, 92 S.Ct. 280, 30 L.Ed.2d 253 (1971). However, a plaintiff cannot state a claim for misrepresentation based upon a failure to disclose unless the defendant had a duty to disclose. Impala Platinum Ltd. v. Impala Sales (U.S.A.), Inc., 283 Md. 296, 389 A.2d 887, 903 (1978) ("nondisclosure does not constitute fraud unless there exists a duty of disclosure"); Fowler v. Benton, 245 Md. 540, 226 A.2d 556, 562 (1967) (without legal duty to disclose defect, defendant cannot be held

liable for misrepresentation), cert. denied, 389 U.S. 851, 88 S.Ct. 42, 19 L.Ed.2d 119 (1967); Walsh v. Edwards, 233 Md. 552, 197 A.2d 424, 427 (1964) (mere silence or nondisclosure, not accompanied by any misstatements, does not constitute actionable fraud). We have already held that Weinberg & Green had no duty of disclosure, arising either from federal securities law or Maryland state law, to inform the Schatzes that Rosenberg's financial status had changed. Accordingly, plaintiffs cannot recover for misrepresentation under state tort law.

IV.

The extent of a law firm's liability for knowingly incorporating a client's misrepresentations into closing documents for a financial transaction presents troubling legal issues. However, we do not sit as an ethics or other attorney disciplinary committee, but as a civil

court with a duty to interpret the securities laws, and the solution to these legal issues cannot be found in the securities laws. As the Seventh Circuit stated in Barker v. Henderson, Franklin, Starnes & Hold, 797 F.2d 490 (7th Cir. 1986):

> We express no opinion on whether the [law firm] did what [it] should, whether there was malpractice under state law, or whether the rules of ethics . . . ought to require lawyers and accountants to blow the whistle in equivalent circumstances. We are satisfied, however, that an award of damages under the securities laws is not the way to blaze the trail toward improved ethical standards in the legal and accounting professions. Liability depends on an *existing* duty to disclose. The securities laws therefore must lag behind changes in ethical and fiduciary standards.

Id. at 497 (emphasis in original). We agree with this statement of policy and affirm the order of the district court.

AFFIRMED.

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND

IVAN N. SCHATZ and JOANNE B. SCHATZ	)	
v.	)	Civil Action No. JH-89-7051
MARK E. ROSENBERG, et al.	)	

MAGISTRATE'S REPORT AND RECOMMENDATION

This case has been referred to the undersigned for proposing recommended findings on all pretrial dispositive matters. Currently pending are motions to dismiss the second amended complaint filed by all defendants.

Plaintiffs, Ivan and Joanne Schatz, filed their second amended complaint in February, 1989.[6] Named as defendants are Mark E. Rosenberg, Steven H. Jaeger, MER

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[6] The original complaint was filed in Bankruptcy Court in June, 1988. (Case No. 88-5-0694-JS; Adversary No. A88-0166-JS). Judge Harvey, acting as chambers judge, granted plaintiffs' motion to withdraw reference to Bankruptcy Court on March 3, 1989. (Paper No. 68).

Enterprises, Inc. (MER), and the law firm of Weinberg and Green. Count I is a claim under the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §1961, et seq., naming Rosenberg and Jaeger; Counts II and III allege violations of §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78a et seq. Count II is brought against Rosenberg and Jaeger while Count III is brought against Weinberg and Green. Count IV alleges violations of §12 of the Securities Act of 1933, 15 U.S.C. §77a et seq, against Rosenberg and MER. Count V is a common law fraud count against Rosenberg and Jaeger, Count VI is aiding and abetting securities fraud brought against Weinberg and Green, Count VII is misrepresentation against Weinberg and Green and, finally, Count VIII seeks a declaration of non-dischargeability in bankruptcy of debts owned by Rosenberg.

Defendants Rosenberg and MER filed a motion to dismiss which was joined by defendant Jaeger, acting pro se (hereafter this motion will be referred to as Rosenberg's motion). They seek dismissal of Counts I, II, III, IV, V and VIII. (Paper Nos. 75 and 76). Defendant Weinberg and Green has also filed a motion to dismiss Counts III, VI, and VII. (Paper No. 74). Oppositions and reply memoranda, as well as supplementary material, have been filed. (Paper Nos. 79, 80, 81 and 82). No hearing is deemed necessary, Local Rule 105.6.

A motion to dismiss pursuant to Fed. R. Civ. P. 12(b)(6) ought not be granted unless "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." Conley v. Gibson, 355 U.S. 41, 45-46 (1957). The Court must consider well pled allegations in a complaint as

true, when ruling on a motion to dismiss. Jenkins v. McKeithen, 395 U.S. 411, 421-22 (1969). Allegations are to be construed liberally in favor of the plaintiff, Scheuer v. Rhodes, 416 U.S. 232, 236 (1974), and the Court must disregard the contrary allegations of the opposing party. A.S. Abell Co. v. Chell, 412 F.2d 712, 715 (4th Cir. 1969).

I. Factual Allegations

As set out by plaintiffs, Ivan Schatz owned a Virginia corporation known as the Virginia Adjustable Bed Manufacturing Corp. (VAMCO) and Joanne Schatz owned Advanced Bed Concepts (ABC) (¶¶24 and 25).[7] Defendant Rosenberg controlled a number of corporations including Yale Sportswear Corp. (Yale), the Back Center, Inc. (BCI), Vertech Management Corp., Back and Bed Co. (BBC), RSJ Acquisitions, Inc., MER

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[7] All paragraph references are to the second amended complaint, unless otherwise noted.

Enterprises, Inc., Mattco and Allied Help [sic] Management (Allied). Defendant Jaeger was formerly a senior vice-president for First American Bank of Maryland and was responsible, in whole or part, for handling loan transactions for Rosenberg's companies. Jaeger went to work for Rosenberg in August or September of 1986, shortly after the bank made substantial loans to Yale. At all relevant times, Weinberg and Green represented Rosenberg, Jaeger and/or the above-named corporations. Plaintiffs allege that Rosenberg and Jaeger, along with other unknown persons, conspired to defraud them and others. (¶¶16-18).

Vertech is concerned with marketing and franchising stores specializing in sales of adjustable beds and other products for persons with bad backs. (¶21).[8] In

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[8] Vertech is currently owned 80% by MER and 20% by plaintiffs.

1985, plaintiff Joanne Schatz and her company, ABC, agreed to become a Vertech franchisee. (¶29). At the same time, Mr. Schatz' company, VAMCO, a manufacturer of adjustable beds, was made a favored supplier to all Vertech stores. (¶29).

In mid-1986, Rosenberg approached the plaintiffs with a proposal to purchase VAMCO and ABC. Negotiations commenced and an agreement was entered on December 31, 1986. Jaeger assisted Rosenberg in the negotiations. During that time, a number of misrepresentations were made regarding Rosenberg's personal and business financial status. (¶¶30-33). The representations included the following: (a) Rosenberg and each of his companies was financially solvent; (b) Rosenberg's net worth was over $7,000,000; (c) Yale Sportswear Corp. was worth over $2.5 million and was a profitable concern; and (d) Allied Health

and Management was a valuable and profitable holding.

The defendants failed to reveal that Rosenberg owed (a) "substantial alimony payments to his first wife, Carol Rosenberg;" (b) Rosenberg had contingent liabilities totaling over $10,000,000, the cause of most of this liability was loan guaranties including loans to Yale Sportswear; (c) on December 31, 1986, the management contracts of Allied Health and Management would be terminated, resulting in the loss of one of Rosenberg's most valuable assets; (d) Yale Sportswear was undercapitalized and was losing money; and (e) Rosenberg would become insolvent should Yale Sportswear collapse. (¶34).

In October of 1986, the parties entered a letter of intent providing that Rosenberg would buy 80% of the plaintiffs' interests in VAMCO and ABC. Plaintiffs were to receive promissory notes totalling

$1.5 million, personally guaranteed by Rosenberg. In November, a copy of Rosenberg's personal financial statement dated March 31, 1986, was provided to the plaintiffs.[9] (¶35). The statement allegedly contains the following misrepresentations. Rosenberg owned 50% of Yale Sportswear that was said to be worth $1,250,000 based on a 1986 estimated cash flow of $500,000 and a profit of $225,000. In truth, Yale had lost $200,000 in 1985 and over $265,000 in 1986 and the cash flow projections for 1986 were not based in fact. (¶35a). Similarly, Allied's cash flow was estimated at $500,000 per year and Rosenberg's 50% share was valued at $1,250,000. In reality, the cash flow figures were substantially lower in 1985 and 1986. Moreover, Rosenberg knew that Allied would lose valuable contracts on

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[9] A copy of that statement was attached to the amended complaint as Exhibit A.

December 31, 1986, which constituted a major portion of its assets. The expected loss of the contracts was not made known to the plaintiffs. Other misrepresentations were made concerning the standing of Rosenberg's indebtedness.[10] (¶35b). Plaintiffs's counsel requested an updated financial statement. (¶50). Rosenberg agreed to provide an update letter. (¶51). At closing on December 31, 1986, the update letter was presented, stating that no material adverse change had occurred in Rosenberg's financial status. (¶64). This letter failed to reveal that Rosenberg had guaranteed a line of credit in the amount of $299,990 on October 14, 1986; had borrowed $200,000 for Yale Sportswear on August 26, 1986; and borrowed $550,000 for Yale Sportswear on July 23, 1986. By December 8, 1986, Rosenberg had guaranteed

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[10] Several of the examples given were transactions entered after the financial statement was prepared. (¶53).

a master demand note issued by Yale Sportswear Corp. in favor of First American Bank of Maryland in the amount of $2,700,000. (¶¶35g, 53 and 56).

Weinberg and Green represented Rosenberg in the negotiations. The March financial statement was made a part of the closing documents that Weinberg and Green prepared. Weinberg and Green is said to have reviewed the financial statement prior to including it in the closing documents. Furthermore, through their representation of Rosenberg and his companies, Weinberg and Green either knew or should have known that the March financial statement was materially false and misleading.[11] The

[11] Other specific allegations against Weinberg and Green include the following. Weinberg and Green also attended various board of directors and shareholders' meetings of Yale and, during those activities and general representation of Yale, should have been aware of the financial difficulty the company was in. (¶¶57 and 58). Weinberg and Green also represented Rosenberg and (continued...)

plaintiffs allege that Weinberg and Green should have either corrected the misrepresentations or withdrawn from representation of Rosenberg. Plaintiffs contend that had Weinberg and Green done either, they would not have entered into an agreement with the defendants. (¶45). Other promises made to the plaintiffs during the negotiations included a representation that Rosenberg would refinance existing debt plaintiffs had previously personally guaranteed for their businesses; that Rosenberg was a "money partner" who would arrange for $1,150,000 in financing from either his own funds or banks; that within five years after VAMCO and ABC were merged into BCI, BCI would be merged with Yale Sportswear and MER would be taken public. (¶46a-c).

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[11](...continued)
Allied in a transaction that occurred on December 31, 1986, which adversely affected the value of Allied. (¶58).

In the closing documents, Rosenberg disclosed that Yale's stock was pledged to First American Bank of Maryland for certain indebtedness. The March 31, 1986, financial statement showed that amount of indebtedness to First American Bank of Maryland to be $350,000 incurred on March 20, 1985. However, in truth, according to plaintiffs, in addition, the stock also secured a $550,000 debt incurred on July 23, 1986, a guaranty for the $2,700,000 line of credit extended to Yale by December 8, 1986, and a $1,000,000 promissory note dated January 2, 1985. (¶53). Plaintiffs assert that Weinberg and Green had represented Rosenberg and Yale in the July, 1986 transaction and, therefore, Weinberg and Green had specific knowledge of that indebtedness. At the same time, Yale executed a master demand not in the amount of $2,000,000 in First American's favor. (¶56).

Rosenberg created MER prior to purchasing his interest in plaintiffs' corporations. The December 31st agreement was between the plaintiffs and MER, but was joined by Rosenberg and Jaeger. (¶63). The plaintiffs claim that they reasonably relied on the financial report, the update letter and the representations of Rosenberg and Jaeger in entering the agreement with MER. (¶¶66 and 67). The negotiations were conducted in person as well as over the telephone and through the U.S. mail. (¶67).

After closing the agreement on December 31, 1986, VAMCO and ABC were merged into BCI. The newly merged company was thereafter known as BBC. The amount of BBC's preexisting debt had been understated to the plaintiffs by over $200,000. (¶71). The plaintiffs worked at BBC, but were unable to cope with its business problems. Plaintiffs were directed to use the ready

cash they had brought with them from their companies to pay BBC's back bills, including $50,000 to Weinberg and Green. (¶72). Because of the financial problems facing Rosenberg and Yale, the refinancing efforts failed. Rosenberg and Jaeger knew that they could not get financing, yet continued to misrepresent this fact to the plaintiffs. (¶74).

Sometime in 1984, Barry Rothberg and Rosenberg had formed Yale Sportswear. Also in 1984, Rosenberg acquired a 50% interest in BBC, then owned by Brian Schiner and Stephen Rutkovitz. (¶75). A partner of Weinberg and Green, Michael Hodes, introduced Rosenberg to these three men and represented that Rosenberg had a net worth in excess of $7,000,000. (¶75). Plaintiffs also allege that Rosenberg knew that Hodes had represented him as being worth over $7,000,000 and perpetuated the image of a successful millionaire until his

bankruptcy filing and that Rosenberg deliberately concealed his financial problems and de facto insolvency in 1986 and 1987 from Schiner, Rutkovitz and Rothberg. (¶75).

In the spring of 1987, Rosenberg and Jaeger told the plaintiffs that a buyer for Yale had been found and that a sale was imminent. In reliance on their representations and believing Rosenberg to be in good financial health, plaintiffs made a "bridge" loan of $150,000 to BBC out of their personal funds. The loan was personally guaranteed by Rosenberg. (¶76). In truth, Yale had a high debt/equity ratio which meant that it had little equity to sell and no sale was imminent. (¶82). Rosenberg and Jaeger willfully and maliciously misrepresented the possible sale of Yale to induce the plaintiffs to loan BBC $150,000 and continue to work for BBC. (¶83). The plaintiffs did not become

aware of the true financial problems facing Yale and Rosenberg until Yale filed for protection under Chapter 11 of the Bankruptcy Code. (¶76).

Through the misrepresentations of Rosenberg's and Yale's financial situations, Rosenberg and Jaeger intended to deceive their victims, plaintiffs, Schiner, Rutkovitz and Rothberg, to provide services to Rosenberg's companies and to cooperate by guaranteeing loans or subordinating debt. (¶77). In December of 1986, Schiner and Rutkovitz, believing in Rosenberg's financial health, agreed to sell their stock in BCI. (¶78). They also accepted unsecured promissory notes in exchange for their MER stock in July of 1987. Barry Rothberg and his wife personally guaranteed loans from First American Bank of Maryland to Rosenberg and Yale made on July 23, 1986. (¶79). In the spring of 1987, Rothberg sold 20% of his

stock in Yale to Rosenberg, becoming a minority shareholder. Plaintiffs contend that Rosenberg knew he was insolvent by November or December of 1986, yet continued to represent himself as being wealthy and solvent in order to keep his victims working for his companies. (¶¶80 and 81).

Rosenberg transferred assets into tenancy by the entirety property, placing them beyond the reach of creditors with the intent of retaining his assets in the event of bankruptcy. (¶84).

In his bankruptcy proceeding, Rosenberg has asserted $1,200,000 in exempt tenancy by the entirety property. He seeks to discharge debt and liabilities on personal guaranties in excess of $20,000,000. (¶87). Plaintiffs believe that the funds used to amass those tenancy by the entirety properties came from themselves and other creditors. (Id.).

II. RICO

Rosenberg and Jaeger move to dismiss the RICO count on the ground that plaintiffs fail to allege a pattern of racketeering activity. (Paper No. 75 at 2-6).[12] The applicable sections, 18 U.S.C. §1962(a), (b), and (c), impose criminal and civil liability on any person who, through a pattern of racketeering activity, (a) uses or invests income to acquire an

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[12] Other arguments were raised in Rosenberg's motion to dismiss the first amended complaint. (Paper No. 18). These were adopted and incorporated along with a supplemental memorandum in support thereof (which itself incorporated defendant Weinberg and Green's motion to dismiss the first amended complaint) and the reply memorandum, as well as defendant Weinberg and Green's motion to dismiss the second amended complaint. (Paper No. 75 at 3 n.2 and 11). Just the two sets of papers on the Rosenberg motions number over 100 pages and run afoul of the length restrictions of Local Rule 105.3. Furthermore, it is unclear which of the earlier RICO arguments remain relevant in light of the additional facts in the second amended complaint. For these reasons, the undersigned will only consider the other papers where specific pages are referenced and the arguments are obviously relevant.

interest in, or to operate an enterprise engaged in interstate commerce; (b) acquires or maintains an interest in or control of such an enterprise; and (c) when employed by or associated with such an enterprise, conducts or participates in the conduct of its affairs. H.J., Inc. v. Northwestern Bell Telephone Co., 109 S.Ct. 2893 (1989). Section 1964(c) provides for treble damages, costs and attorneys fees for successful plaintiffs. In H.J., Inc., the Supreme Court considered what was necessary to establish a pattern of racketeering. First, the definition of "pattern of racketeering activity" in §1961(5) "requires at least two acts of racketeering activity one of which occurred after [October 15, 1970] and the last of which occurred within 10 years (excluding any period of imprisonment) after the commission of a prior act of racketeering activity." 109 S.Ct. at 2899.

Additionally, it is necessary to show "that the racketeering predicates are related and <u>that they amount to or pose a threat of continued criminal activity</u>." 109 S.Ct. at 2900. "'[C]riminal conduct forms a pattern if it embraces criminal acts that have the same or similar purposes, results, participants, victims, or methods of commission, or otherwise are interrelated by distinguishing characteristics and are not isolated events.'" 109 S.Ct. at 2901 (<u>quoting</u> 18 U.S.C. §3575(e)).

It is more difficult to enunciate a general test for continuity, but guidance was provided to lower courts. "'Continuity' is both a closed- and open-ended concept, referring either to a closed period of repeated conduct, or to past conduct that by its nature projects into the future with a threat of repetition." 109 S.Ct. at 2902 (citation omitted). Further:

> A party alleging a RICO violation may demonstrate continuity over a closed period by proving a series of related predicates extending over a substantial period of time. Predicate acts extending over a few weeks or months and threatening no future criminal conduct do not satisfy this requirement: Congress was concerned in RICO with long term criminal conduct. Often a RICO action will be brought before continuity can be established in this way. In such cases liability depends on whether the threat of continuity is demonstrated.

Id. (citation omitted).

The determination of continuity is fact-based and the Court provided several examples of how the continuity element might be satisfied. One such situation is where the related predicates themselves involve a distinct threat of long-term racketeering activity, either implicit or explicit. As illustration the Court cited a case where hoodlums sell insurance to storekeepers in a neighborhood, returning each month to collect their premium. A separate situation is where the predicate

acts "are part of an ongoing entity's regular way of doing business" such as "a long-term association that exists for criminal purposes." This is not limited to organized crime. In accordance with the foregoing analysis, the Court reversed and remanded the district court dismissal of a case where it was alleged that, over at least a six-year period, numerous bribes were given to five members of the Minnesota Public Utilities Commission to persuade them to approve unfair and unreasonable rates for Northwestern Bell. The Court reasoned that the alleged acts of bribery had a common purpose of influencing the commissioners, that a six-year period may be sufficient to satisfy the continuity requirements or, alternatively, that a threat of continuing racketeering activity might be established if the bribes were shown to be a regular way of conducting business.

The Fourth Circuit reconsidered the case of Walk v. Baltimore and Ohio Railroad, 890 F.2d 688 (4th Cir. 1989), in light of H.J., Inc. This time, the court reversed the dismissal of RICO claims in a case where the minority shareholders were forced out of a single corporate structure. The prior dismissal had focused improperly on the closed ended character of the acts and had not given sufficient consideration to the many alleged acts of mail and wire fraud over a ten-year period. The Fourth Circuit noted the Supreme Court suggestion in H.J., Inc. that the substantial duration requirement would not be satisfied by conduct lasting "only a few weeks or months and threatening no future criminal conduct . . .," but held that a six-year period might satisfy the requirement.

Another case decided since H.J., Inc. is particularly helpful in illustrating the test for a pattern. In Menasco, Inc. v.

Wasserman, 886 F.2d 681 (4th Cir. 1989), the Court of Appeals for the Fourth Circuit upheld the lower court's dismissal of the RICO claims, but granted leave to amend in light of the decision in H.J., Inc. A defendant in that case, Barry Wasserman, allegedly induced two physicians to invest in the oil business. Two new oil companies would be formed, Menasco, Inc. and Lucky Two, Inc. The two doctors would serve as presidents and directors of the corporations. Wasserman was an attorney and principal of Sounion Petroleum, Inc., also named as a defendant. The plaintiffs contended, inter alia, that Wasserman acted to benefit Sounion by soliciting assignments of Rights of Action from plaintiffs and renegotiating a lease on an oil well, to the detriment of plaintiffs and the benefit of Sounion, and then transferring funds from Sounion to other companies to shelter his funds and render

himself judgment proof. 886 F.2d at 682. The Menasco court noted that the test of continuity plus relationship is fact specific and commensensical rather than formulaic and said:

> Continuity, in turn, refers "'either to a closed period of repeated conduct, or to past conduct that by its nature projects into the future with a threat of repetition' [H.J., Inc.] at 2909 (emphasis added). To satisfy the continuity element, a plaintiff must show that 'the predicates themselves amount to, or . . . otherwise constitute a threat of, continuing racketeering activity." (Id. at 2901) (emphasis in original). Significantly, "[p]redicate acts extending over a few weeks or months and threatening no future criminal conduct do not satisfy this requirement: Congress was concerned in RICO with long-term criminal conduct." (Id. at 2902).

886 F.2d at 683-84. The court found that the plaintiff's allegations failed to

> satisfy the continuity prong of RICO's pattern requirement. Defendants' action were narrowly directed toward a single fraudulent goal. They involved

> a limited purpose: to defraud Menasco, Inc. and Lucky Two, Inc. with respect to their oil interests. They involved but one perpetrator: Wasserman. They involved but one set of victims: Menasco and Lucky Two. Finally, the transaction took place over approximately one year. Clearly, these acts do not constitute "ongoing unlawful activities whose scope and persistence pose a special threat to social well-being."

886 F.2d at 684 (quoting International Data Bank Ltd. v. Zepkin, 812 F.2d 149, 155 (4th Cir. 1987)).

Plaintiffs contend that Rosenberg committed multiple acts of wire, mail and securities fraud in connection with (1) acquiring VAMCO and ABC; (2) inducing the $150,000 loan; (3) acquiring the interests of Schiner and Rutkovitz in BCI and later, MER; (4) inducing the Rothbergs to guaranty debt for Yale; and (5) acquiring 20% of Rothberg's interest in Yale. The complaint states that "[t]he essence of Rosenberg and Jaeger's scheme to defraud was to . . . induce the plaintiffs and additional

victims, Schiner, Rutkovitz or Barry Rothberg, to continue to provide services for Rosenberg or Rosenberg-controlled companies . . ." (¶77). Rosenberg aimed to keep his companies "viable and [to] rescue Rosenberg from insolvency." (¶81). Plaintiffs are, therefore, alleging a single scheme by Rosenberg and Jaeger to keep Rosenberg's companies afloat. This scheme was ended in failure when Yale and then Rosenberg filed for bankruptcy.[13] Therefore, it is a closed-ended scheme and must be analyzed as such.

While it is true that multiple predicates within a single scheme may constitute criminal activities which have long-term and widespread consequences that might constitute ongoing, unlawful

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[13] The date of Rosenberg's personal bankruptcy filing is not contained in the second amended complaint. Yale is said to have filed in September, 1987 (¶125), but that information is not in any of the paragraphs contained in the RICO count (¶¶1-110).

activities whose scope and persistence pose a special threat to social well-being, this scheme does not qualify. Here, plaintiffs have alleged, at most, five victims. These are Ivan and Joanne Schatz, Schiner, Rutkovitz and Rothberg.[14] The Menasco court viewed Wasserman and his company, Sounion, as one defendant. Similarly, here, defendant Rosenberg and MER may be viewed as one defendant. Even adding defendant Jaeger would not significantly change the scenario because the purpose of the defendants' actions was said to be to keep the companies they controlled viable. Thus, there are, at most, two defendants with one goal. There are no more than five victims and the acts allegedly took place

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[14] The paragraphs pertaining to other victims are nos. 18, 20, 23, 27, 28, 38, 75, 77 and 85. Plaintiffs several times allege that "others" were victimized. The vague allusion to other unidentified victims cannot be enough to satisfy RICO's requirement of a pattern.

over no more than a 1 1/2 year period.[15] The nature of the alleged fraud does not lend itself to repetition - but instead had to succeed or fail (as it did) in a relatively short period of time. As in Menasco, these acts clearly do not constitute "ongoing unlawful activities whose scope and persistence posed a special threat to social well-being."

Accordingly, it is respectfully recommended that plaintiffs' RICO claim be dismissed. The second amended complaint was filed before the Supreme Court decided H.J., Inc., raising the question whether the dismissal should be with or without

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[15] The defendants claim that the wire and mail fraud occurred during 1986 and 1987. (¶¶107-108). They also stated that they were approached by Rosenberg with this business proposition in mid-1986. (¶30). No specific acts of wire, mail or securities fraud were alleged as occurring any earlier than that. Despite plaintiffs' claims in ¶¶32 and 67 that communications were made over the telephone and through the mail, no specific incidents are detailed in the complaint.

prejudice. The Fourth Circuit has expressed an inclination to allow leave to amend a complaint filed before H.J., Inc. was decided, Menasco, 886 F.2d at 685. Here, plaintiffs have already amended twice, albeit not based on any deficiency declared by a court. Therefore, dismissal without prejudice is appropriate.

III. Securities Claims

A. Statute of Limitations

The defendants claim that all counts making securities claims are time barred because they were not brought within the one-year statute of limitations. Plaintiffs concede that a one-year statute of limitations applies both to §12(2) of the 1933 Act[16] and to §10(b) of the 1934

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[16] Title 15 U.S.C. §77m provides:

> No action shall be maintained to enforce any liability created under section 77k or 77l(2) of this title unless brought within one year after the discovery of the untrue statement or the
> (continued...)

Act.[17] They further agree that facts indicating that a §12(2) securities claim is timely brought must be affirmatively plead, but argue that the same is not necessary for the §10(b) violations.

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[16](...continued) omission, or after such discovery should have been made by the exercise of reasonable diligence, or, if the action is to enforce a liability created under section 77l(1) of this title, unless brought within one year after the violation upon which it is based.

[17] When the federal statute creating a cause of action contains no statute of limitations, an analogous statute of limitations of the forum state is applied. Here, that period is one year under Md. Corp. & Ass'ns. Code Ann. §11-703(f) (Maryland's blue sky law). O'Hara v. Kovens, 625 F.2d 15, 17 (4th Cir. 1980), cert. denied, 449 U.S. 1124 (1981); Morley v. Cohen, 610 F. Supp. 798, 818 (D.Md' 1985). That section provides, in part:

> An action may not be maintained . . . unless brought within one year after the discovery of the untrue statement or omission, or after the discovery should have been made by the exercise of reasonable diligence.

Finally, plaintiffs claim that they have alleged sufficient facts, in any event.

The original complaint was filed on June 27, 1988, and the securities law violations allegedly occurred on or about December 31, 1986, when the plaintiffs transferred their stock in VAMCO and ABC and received the promissory notes. The second amended complaint contains sparse reference to plaintiffs' discovery of the alleged fraud . First, ¶76 asserts that "when Yale filed for bankruptcy, plaintiffs first became aware of the true depth of Yale's financial problems and Rosenberg's true financial situation." Significantly, no date is given for the bankruptcy filing. This is the <u>only</u> reference to discovery through the end of Count III. In Count IV, in ¶125, plaintiffs first recite specifically that:

> Plaintiffs were unaware of the material misrepresentations and omissions, and in the exercise of reasonable care, could not have

> known of such misrepresentations and omissions until September of 1987 when Yale declared bankruptcy. The Plaintiffs acted diligently at all times, but failed to discover the true facts because they received convincing explanations and assurances from Rosenberg and Jaeger from January through September of 1987 and because they were busy working for BCI under Rosenberg's and Jaeger's direction.

Beyond that, plaintiffs argue that other facts alleged in the second amended complaint imply that they had no earlier knowledge of the fraud and that they acted diligently.

Concededly, a plaintiff's burden under 15 U.S.C. §77m is to plead compliance with the statute of limitations, including a statement of the due diligence in seeking discovery of the misstatements, Shotto v. Laub, 635 F. Supp 835, 837 (D.Md. 1986). Thus, for Count IV and a portion of Count VI, at least, plaintiffs must meet that requirement. They contend that this affirmative pleading requirement does not

apply to Counts II and III, but is instead an affirmative defense to be plead by defendants. The cases they cite do not so hold.

The court in Brick v. Dominion Mortgage & Realty Trust, 442 F. Supp. 283, 304 (W.D.N.Y. 1977), did not hold that it was unnecessary to allege fraudulent concealment in the complaint, but only that such allegations as were made there were sufficient to withstand a motion to dismiss. Further, In re: U.S. Oil and Gas Litigation, 1988 U.S. Dist. Lexis 2217* (S.D.Fla. 1988), makes the unremarkable statement that the plaintiffs' contention that "the fraud was not reasonably discoverable before it was made public by the filing of the FTC enforcement action" . . . "raises a fact question not resolvable as a matter of law." The cases cited by the Florida court are no more helpful. Cavic v. Grand Bahama Development

Co., Ltd., 701 F.2d 879, 888 n.6 (11th Cir. 1983), dealt with the issue after a jury determination; Briskin v. Ernst & Ernst, 589 F.2d 1363, 1367 n.3 (9th Cir. 1978), applied California law on a summary judgment motion; and Boyd v. Merrill Lynch, Pierce, Fenner & Smith, 611 F. Supp. 218, 220 (S.D. Fla. 1985), found the allegations sufficient to toll the Florida statute of limitations, although the court would "be more comfortable had plaintiff alleged that defendants concealed their activities despite her numerous inquiries."

On the other hand, other decisions have found "no significant difference, with respect to the pleading requirements, between tolling a limitation period by express statutory provisions and by the equitable doctrine of fraudulent concealment." Conley v. First Jersey Securities, Inc., 543 F. Supp. 368, 374 (D.Del. 1982).

As stated above, the second amended complaint is silent through Count III as to when the Yale and Rosenberg bankruptcies were filed or why the alleged fraud could not have been discovered earlier. Accordingly, it is respectfully recommended that Counts II and III be dismissed, unless plaintiffs amend within an appropriate period of time to allege facts sufficient to overcome a statute of limitations problem.

Defendants' claim that allegations made earlier in the first amended complaint preclude the making of such assertions should be rejected. Whatever evidentiary use defendants may later make of a now discarded pleading does not affect plaintiffs' ability to plead facts as they claim them to be.

Count IV and Count VI are not subject to dismissal on these grounds. Count IV, in ¶125, makes the necessary factual

allegations that plaintiffs discovered the misrepresentations in September, 1987, and that they were sufficiently diligent before that because "they received convincing explanations and assurances from Rosenberg and Jaeger from January through September of 1987 and because they were busy working for BCI under Rosenberg's and Jaeger's direction." Count VI, as all counts from II on, incorporates all earlier paragraphs, including the necessary allegations in ¶125. For these reasons, Counts IV and VI should not be dismissed on statute of limitations grounds.

B. Promissory Notes as Securities

The Rosenberg defendants raise a threshold issue regarding Count IV: whether the promissory notes here constitute securities within the meaning of ¶12 of the 1933 Act.

Plaintiffs contend that they exchanged an 80% interest in their businesses for

unsecured promissory notes, issued by MER and personally guaranteed by Rosenberg, totalling $1.5 million. (¶¶35, 37, 62, and 121-28). They also state that they would not have entered the agreement without Rosenberg's guaranty. (¶122). The notes are tendered to MER and Rosenberg in ¶127.

Defendants move to dismiss this count arguing that the promissory notes in question were not securities. The basis for the argument is that plaintiffs could not have reasonably expected to derive profits from the entrepreneurial or managerial efforts of others because Mr. Schatz was the president and chief operating officer of BCI and Vertech.[18] (Paper No. 75 at 7-9). Defendants refer to the December 31, 1986, agreement (the

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[18] Defendants also state that when promissory notes are given as partial consideration for the acquisition of a business they are not generally held to be securities. The argument is not developed.

agreement) between the parties to support this argument and invite the Court to convert this portion of the motion into a motion for summary judgment. (Id. at 9 n.5).

Plaintiffs admit that the ultimate question of whether an investment is a security is one of law, but argue that where the facts are in dispute the question cannot be decided on a motion to dismiss and that the defendant bears the burden of demonstrating that the notes are not securities. (Paper No. 50 at 34-35). Plaintiffs, however, have not pointed to any disputed facts. Rather, they set out the uncontroverted terms of the notes and allege that, despite the fact that Mr. Schatz was the president of BCI, the company was "owned and controlled by Mark

E. Rosenberg through MER Enterprises, Inc." (Id. at 36).[19]

The parties to the agreement are MER and Mr. and Mrs. Schatz.[20] MER is identified by plaintiffs as a holding company, owned 5% by them and 95% by Rosenberg, established to purchase some portion of the stock in VAMCO, ABC and BCI. (¶¶19, 35, 36 and 61). Plaintiffs identify its assets as Vertech and BBC.[21] (¶¶20 and 21). Plaintiffs allege that the parties

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[19] Plaintiffs also point to §5.2.2 of the agreement providing for additional compensation should the companies' cash flow exceed $400,000. That provision comes within the purchase price section, payment of which is not tied to the notes. Copies of the notes attached to plaintiffs' opposition show they are to earn 9% interest and that all principal and accrued interest remaining unpaid on December 31, 1996, "shall be due and payable on such date." (§b).

[20] Rosenberg and Jaeger join the agreement "for the purposes of making certain covenants in their presentations to the Plaintiffs." (¶63).

[21] BBC is the current name of the company formerly known as BCI and consisting of BCI, VAMCO and ABC.

planned eventually to merge BCI with Yale, said to be owned and controlled by Rosenberg, and then to take MER public. (¶46c). It was understood that Rosenberg would handle financing and raise enough money to pay existing debts and provide working capital for the new firm. (¶46b).

Attached to plaintiffs' opposition are copies of the agreement and the promissory notes. (Paper No. 80, Exhibit B). Each note was in the amount of $375,000 with the interest payable quarterly beginning March 31, 1987, at a rate of 9% per annum. The borrower could defer the interest payments in the years 1987 and 1988. Principal was payable annually on March 31st beginning in 1988. Payment was to be 6.25% of the net cash flow of the Back Companies for the preceding years.[22] All principal and accrued interest remaining unpaid on

[22] The Back Companies are defined as BCI, Vertech, VAMCO and ABC.

December 31, 1996, "shall be due and payable in full on such date." Rosenberg personally guaranteed the notes and warranted that he and the borrower are related entities and share financial interests.

"Whether a particular interest is a 'security' is both a question of subject matter jurisdiction and an element of [a plaintiff's] asserted claims under the federal securities laws." Rivanna Trawlers v. Thompson Trawlers, 840 F.2d 236, 289 (4th Cir. 1988); Goldman v. Gallant Securities, Inc., 878 F.2d 71 (2d Cir. 1989). In Rivanna Trawlers, plaintiffs claimed that a general partnership interest was a security. Defendants moved to dismiss and, according to Justice Powell, the lower court appropriately converted a motion to dismiss into a motion for summary judgment and decided the issue on the merits. Similarly, here, the defendants

invite the Court to convert this portion of the motion to a motion for summary judgment.

> In a motion for summary judgment, the moving party is entitled to summary judgment if, viewing the evidence in the light most favorable to the nonmoving party, there is no genuine issue as to any material fact and if the moving party is entitled to judgment as a matter of law. Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 250, 106 S.Ct. 2505, 2511, 91 L.Ed.2d 202 (1986). The party opposing a properly supported motion for summary judgment may not rest upon mere allegations or denials of his pleading, but must set forth specific facts showing that there is a genuine issue for trial. Id. 106 S.Ct. at 2514.

Rivanna, 840 F.2d at 239-40.

The Securities Act of 1933, 15 U.S.C. §77(b)(1) defines a security as follows:

> The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of

> deposit for a security, fractional undivided interest in oil, gas or other mineral rights, or, in general, any interestor instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing.

Despite the "any note" language, not every note is a security. Oliver v. Bostetter, 426 F. Supp. 1082, 1085 (D.Md. 1977) (Blair, J.), and cases cited therein. Most circuits that have considered the question have adopted the commercial-investment test to determine when a promissory note is a security:

> Under this test, the court looks to see whether a transaction more closely resembles typical investment situations or typical mercantile or commercial transactions to determine the applicability of the security laws. The 'investment vs. commercial' approach focuses on the degree to which the plaintiff is dependent upon the expertise and efforts of others.

Futura Development Corp. v. Center Corp., 761 F.2d 33, 40-41 (1st Cir.), cert. denied, 474 U.S. 850 (1985). Accord, Association of American R.R. v. U.S., 603 F.2d 953 (D.C. Cir. 1979); CNS Enterprises, Inc. v. G & G Enterprises, Inc., 508 F.2d 1354 (7th Cir.), cert. denied, 423 U.S. 825 (1975); McClure v. First National Bank, 497 F.2d 490 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975); Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974); Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973).

Judge Blair concluded that the Fourth Circuit would adopt that test if faced with the questions. Oliver, 426 F. Supp. at 1085. Later, Judge Wilkins, in South Carolina National Bank v. Darmstetter, 622 F. Supp. 226, 229 (D.C.S.C. 1985), aff'd, 813 F.2d 1227 (4th Cir. 1986), cert. denied, 479 U.S. 1065 (1987), echoed that conclusion and pointed out that language in

Lawler v. Gilliam, 569 F.2d 1283, 1287 (4th Cir. 1987), supported their view.

It is less clear how to gauge the nature of the note. The First Circuit examines each case considering the combined effect of:

> [t]he size of the offering; whether there is, by necessity, reliance on the expertise of the issuer; the purpose of the issuer in executing the note; and the economic inducements held out to the prospect . . . the degree to which the profit on the note is in the hands of the maker rather than the payee; whether the object of the holder was to acquire an interest in the property or enterprise; whether the note was primarily commercial because it was serving as a "cash substitute" for the purchase price; and whether the return on the note was predetermined or could reasonably be anticipated or was subject to the managerial efforts of the maker.

Futura Development Corp. v. Center Corp., 761 F.2d at 41. The Fifth Circuit also follows a case by case approach examining "(t)he economic realities underlying (the) transaction . . ." Williamson v. Tucker,

645 F.2d 404, 427 (5th Cir.), cert. denied, 454 U.S. 897 (1981), quoting United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849, reh'g denied, 423 U.S. 884 (1975). Without identifying all potentially relevant factors, the Fifth Circuit has considered significant: an expectation of profit from the enterprise, Bellah v. First National Bank of Hereford, Texas, 495 F.2d 1109 (5th Cir. 1974); and whether notes were offered to some class of investors or acquired for speculation or investment, or issued to rejuvenate an enterprise. S.E.C. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974).

Judge Blair believed the better approach to be "to examine the note sub judice for its investment aspects. If the note meets the test set forth in SEC v. W.J. Howey Co., [328 U.S. 293 (1946)] for determining whether an investment contract is a security, then the note is a security

. . . ." _Oliver_, 426 F. Supp. at 1185-86. The _Howey_ test for an investment contract requires (1) the investment of money (2) in a common enterprise from which (3) profits are expected solely from the efforts of a promoter or third party. 328 U.S. at 298-99. The Supreme Court has said that the touchstone of the test is "an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." _Forman_, 421 U.S. at 852.

The third prong of the test is the one at issue in this case and the one over which most disputes have centered. It has been liberalized in several circuits so that "solely" is not given a literal interpretation. In _Williamson_, 645 F.2d at 418, the Fifth Circuit agreed with the Ninth Circuit's view that the test is "whether the efforts made by those other than the investor are the undeniably

significant ones, those essential managerial efforts which affect the failure or success of the enterprise," S.E.C. v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir. 1973), cert. denied, 414 U.S. 821 (1973). The Williamson approach was applied by the Eleventh Circuit in Gordon v. Terry, 684 F.2d 736, 741 (11th Cir. 1982), cert. denied, 459 U.S. 1203 (1983).

To support their argument, defendants point to the agreement, §3.7, providing for the employment of Mr. Schatz as president and chief operating officer of BCI and Vertech and the employment of Mrs. Schatz in a management and consulting capacity.[23]

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[23] The test of §3.7 provides:

> for the employment of Mr. Schatz for the years 1987 and 1988 as President and Chief Operating Officer of BCI, Vertech, VAMCO and ABC and their successors with broad operating authority and responsibilities, subject only to supervision of the

(continued...)

At first blush, defendants' argument appears well-taken. Mr. Schatz was president and chief operating officer of the Back Companies. Thus, the argument that Rosenberg controlled the companies and that they were dependent on his efforts for

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[23](...continued)
Boards of Directors of such corporations and to the business plans inclusive of operating budgets and personnel policies approved by the Boards of Directors of such corporations. Mr. Schatz' compensation under the Employment Agreement shall consist of (i) an annual salary of $75,000; (ii) an annual business expense of $25,000; and (iii) a new automobile selected by Mr. Schatz with the purchase price not the exceed $25,000.

The combined budgets for BCI, Vertech, VAMCO and ABC for the years 1987 and 1988 shall include the following compensation for Joanne B. Schatz in consideration of consulting and management services to be rendered by Mrs. Schatz: (i) an annual salary of $48,000; and (ii) a new automobile selected by Mrs. Schatz with a purchase price not to exceed $20,000.

(Paper No. 80, Ex. B at §3.7).

their expected profits falters. A close examination of the record, however, reveals the potential flaws in the defendants' position. The agreement itself muddies the water and prevents a grant of summary judgment. Although none of the parties contend in their moving papers that MER owned Yale, §3.1 - titled "Corporate Status" - asserts that "[b]uyer [MER] has at least a fifty percent (50%) ownership interest in Yale Sportswear Corporation . . . ." Yale has been identified as a Rosenberg controlled corporation whose financial status played an important role in inducing plaintiffs to enter the agreement. It is not contested that plaintiffs had no role in Yale's management. If, as the agreement reflects, MER owned half of Yale, there is at least a question raised about whether Rosenberg's efforts in managing Yale were the undeniably significant ones required to

convert these promissory notes into securities. Furthermore, the notes were not to be paid in full until the end of 1996, long after the time frame covered in the employment contracts. Finally, the payment of the notes from the net cash flow of the Back Companies implicates their overall financial health, including payment of other debts. Rosenberg was surely involved in that aspect of the Back Companies.

Given the current state of the record, granting summary judgment would not be appropriate and it is respectfully recommended that the defendants' motion for summary judgment on Count IV be denied.

C. The Fraud Counts - Particularity

Rosenberg's attempts to incorporate earlier motions and memoranda are especially unfortunate in regard to their argument that the fraud counts are not plead with sufficient particularity. This

Court should not have to compare the prior complaints with the current one and then divine which arguments still apply.

D. Weinberg and Green

Defendant Weinberg and Green moves to dismiss Count III, alleging a primary violation of §10(b) of the Securities Exchange Act of 1934 and Count VI, alleging aiding and abetting liability under §10(b) of the 1934 Act and §12(2) of the Securities Act of 1933.

1. Count III

This count alleges primary liability of Weinberg and Green for violations of §10(b) of the Securities Exchange Act of 1934 and Rule 10(b)(5) set out in 17 C.F.R. 240.10b-5.

Section 10(b) is codified as 15 U.S.C. §78j(b). That section makes it unlawful for any person, directly or indirectly, in connection with the purchase or sale of a security to use or employ any "manipulative

or deceptive device or contrivance in contravention [of federal securities regulations]."

17 C.F.R §240.10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

17 C.F.R. §240.10b-5.

In its motion to dismiss, Weinberg and Green argues that transmitting information provided by a client or drafting documents containing a client's misrepresentations do

not equal a misrepresentation by an attorney and that, in the absence of misleading statements, a duty to disclose only exists when there is a fiduciary relationship between the parties.

In Schlifke v. Seafirst Corp., 866 F.2d 935, 943 (7th Cir. 1989), a case relied on by both plaintiffs and defendants, the court set out the elements of primary liability under §10(b) and Rule 10b-5. These include (1) an untrue statement of material fact or an omitted material fact that rendered the statements made misleading, (2) in connection with a securities transaction, (3) with the intent to mislead, and (4) which caused plaintiff's loss. Before liability can attach to omissions, a further element must be shown: "When an allegation of fraud is based upon non-disclosure, there can be no fraud absent a duty to speak." Chiarella v. United States, 445 U.S. 222, 235 (1979);

<u>Jett v. Sunderman</u>, 840 F.2d 1487, 1493-97 (9th Cir. 1988); <u>Barker v. Henderson, Franklin, Starns and Hold</u>, 797 F.2d 490, 495-96 (7th Cir. 1986). <u>Accord</u>, <u>Rose v. Arkansas Valley Environmental and Utility Authority</u>, 562 F. Supp. 1180, 1206-1207 (W.D.Mo. 1987). The mere possession of nonpublic information does not trigger a duty to disclose under §10(b). The duty cannot come from the securities regulations. Rather, the duty arises "from a relationship of trust and confidence between parties to a transaction," <u>i.e.</u>, an outside fiduciary relation, <u>Chiarella</u>, 445 U.S. at 230; <u>Jett</u>, 840 F.2d at 1493. To hold otherwise would result in a circular inquiry. <u>Barker v. Henderson, Franklin, Starns & Hold</u>, 797 F.2d 490, 496 (7th Cir. 1986). Thus, in order to state a claim of primary liability against Weinberg and Green, plaintiffs must allege either a fiduciary duty running to them <u>or</u> an

affirmative misrepresentation by Weinberg and Green.

a. Duty

Cases cited by plaintiffs to establish a duty are inapposite. For example, in Renovitch v. Stewardship Concepts, Inc., 654 F. Supp. 353, 359 (N.D.Ill. 1987), the attorneys were alleged to have either helped prepare or approved statements made in the brochures used to induce the sale of the securities and liability on an aiding and abetting theory was urged. Here, plaintiffs do not allege that this defendant had any role in the preparation of the March 31st financial statement or even that it had seen the statement before it was presented to them by Rosenberg. The allegations concerning the update letter merely state that the firm drafted or assisted in drafting the letter for Rosenberg, forwarded a copy of the letter to Arent, Fox and discussed and agreed on

the language, referencing the letter, to be used in the agreement. Nor does the plaintiffs' attempted reliance on the Fourth Circuit's decision in Bonavire v. Wampler, 779 F.2d 1011, 1014-16 (4th Cir. 1985), support the argument that Weinberg and Green was under a duty to disclose Rosenberg's alleged misrepresentation. Bonavire involved common law fraud where an attorney had affirmatively represented to certain investors that her client was an honest man who was capable of performing as promised.

In Schlifke, the court rejected an argument that a bank had an independent duty arising from a quasi-fiduciary relationship with investors based upon a contractual relationship between plaintiffs and the bank. The court said:

> [T]he Supreme Court has held that parties to an impersonal market transaction owe no duty of disclosure absent a fiduciary or agency relationship, prior dealings or circumstances such

> that one party has placed trust and confidence in the other. See Dirks v. SEC, 463 U.S. 646, 653-54, 103 S.Ct. 3255, 3260-61, 77 L.Ed.2d 911 (1983); Chiarella, 445 U.S. at 232, 100 S.Ct. at 1116. In a factually similar case, Jett v. Sunderman, 840 F.2d 1487, the Ninth Circuit recently held that a bank that had made a loan to a limited partnership owed no duty of disclosure to the investors because
>
> > [the Bank] had no relationship with the investors prior to their making the investment . . . [T]he Bank had no communications with the investors and did not initiate the transaction or participate in it in any way that would induce the investors to rely on the bank to disclose information . . . .
>
> Id. at 1493.

Schlifke, 866 F.2d at 945. The court went on to find that the contract between the parties did not create a fiduciary relationship, and the bank's lack of direct dealings with the investors and mere drafting of loan documents and establishment of requirements to insure its interests as a lender was "not the sort of prior dealings or circumstances creating a

relationship of trust and confidence as envisioned by Chiarella." (Id. at 945-46) (footnote omitted).

Barker v. Henderson, 797 F.2d at 493, concerned the issuance of bonds and notes secured by its interest in land to be developed as a retirement village by the Michigan Baptist Foundation, Inc. (the Foundation). Named as defendants, among others, were a law firm and an accounting firm, who had provided, respectively, legal advice and accounting services to the Foundation. In October of 1976, the trustee for the bonds refused to participate further. For the next seventeen months, the Foundation continued to sell unsecured notes. The court assumed that material information was omitted from the materials used to sell the bonds and assumed that the firms should have been aware that there were substantial risks involved in the sale of the bonds and the

development project. Each firm reviewed the selling documents during 1974-78. Neither attempted to prevent further sales and both facilitated sales by answering questions from the trustee that led to its continued dealing with the Foundation through 1976. Specifically cited as an example of the Law Firm's acts is that it allowed the trustee to "conclude that there were '[n]o known defaults' under the indenture . . . but a jury might conclude that the Law Firm should have known the trustee was interested in whether any legal problems, such as potential liabilities under the securities law, had arisen." 797 F.2d at 493. It was undisputed that, _inter alia_, neither firm had (1) received or approved the materials used to sell the securities in the relevant time period, nor (2) received proceeds from the sales, or had a representative on the Foundation's board. Nor had the Firm's name been used

on any documents used to sell the securities.

In granting summary judgment, the court commented that "[n]either lawyers nor accountants are required to tattle on their clients in the absence of some duty to disclose. To the contrary, attorneys have privileges not to disclose." (Id. at 497) (citations omitted).

Plaintiffs here do not allege a relationship with Weinberg and Green that would give rise to independent duty to disclose to them.[24] There is not the

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[24] Plaintiffs' attempted reliance on Maryland Rules of Professional Responsibility 7-102(B) also fails. There is no support in either of the cases cited that Weinberg and Green owed the Shatz' a duty to withdraw. See, In re Flight Transportation Corporation Securities Litigation, 593 F. Supp. 612, 617-18 (D.Minn. 1984) (duty arose from the defendant's preparation of allegedly fraudulent and misleading prospectuses); Flaherty v. Wineberg, 492 A.2d 618 (Md. 1985) (misrepresentation claim sufficiently alleged duty arising from intent to benefit plaintiffs). The source of any duty is distinct from the standards
(continued...)

slightest indication that plaintiffs had any contact with the defendant prior to the incident in question. Plaintiffs do not allege any direct connection between them and Weinberg and Green. The communications they point to in ¶¶48-59 took place between two law firms representing separate clients. To find that this "relationship," standing alone, created a fiduciary relationship between Weinberg and Green and the Schatz' files in the face of long-established legal practice. Therefore, the only way this defendant can have violated §10(b) is if it affirmatively acted to mislead the Schatz'.

b. Allegations of Affirmative Misrepresentations

Most of the allegations against Weinberg and Green do not involve statements or misrepresentations of the law

[24](...continued) of care in performing a duty, e.g. Waldman v. Levine, 544 A.2d 683 (D.C.App. 1988).

firm. For example, in ¶51 plaintiffs say that Weinberg and Green told Arent, Fox that Rosenberg would supply an update letter to be used in the closing documents. Even assuming the letter omitted material information, merely drafting or assisting to draft a letter containing a client's misrepresentations signed by the client does not render the letter a misrepresentation of the attorney. One paragraph of the complaint, however, is ambiguous. Paragraph 55 reads:

> Weinberg and Green knew at the time they represented to Arent, Fox that no material change had occurred in Rosenberg's financial position since the March 31, 1986, financial statement that, in fact, there had occurred several material adverse changes in Rosenberg's financial situation.

(Emphasis added). If Weinberg and Green made a separate representation of its own to Arent, Fox, as the above language implies, it may have made its own representation and might have been obliged

to correct any misrepresentation. While plaintiffs may be able to amend their compliant to state a claim against this defendant, this vague allusion to an affirmative act is too slender a reed on which to allow this count to go forward. This is particularly so under the requirement that allegations of fraud be plead with particularity, Fed. R. Civ. P. 9b, specifying time, place and content of alleged misrepresentation. Before a law firm should be held to answer for allegedly fraudulent acts, plaintiffs should be required, at a minimum, to specify what was said to whom and where and when the communication occurred.

Accordingly, it is respectfully recommended that Count III be dismissed without prejudice to allow plaintiffs the opportunity to cure, if they can, this pleading deficiency.

2. <u>Count VI</u>

Count VI alleges aiding and abetting liability under §§12(2) of the Securities Act of 1933 and 10(b) of the Securities Exchange Act of 1934 and 17 C.F.R. §240.10b-5.[25] Plaintiffs allege that

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[25] The provisions of §10(b) of the 1934 Act and Rule 10b-5 are set forth in the discussion of Count III. Section 12 of the 1933 Act provides:

> Any person who -
>
> (1) offers or sells a security in violation of section 77e of this title, or
>
> (2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or

(continued...)

Weinberg and Green knowingly or recklessly assisted Rosenberg and Jaeger's misrepresentations by providing substantial assistance to them in participating in the negotiations, drafting documents and conducting the closing. (¶¶136-147). It is claimed that Weinberg and Green owed the plaintiffs a duty either to disclose the misrepresentation or to withdraw from representing Rosenberg or his companies. Because they did neither, the plaintiffs

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[25](...continued)
omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

15 U.S.C. §771 (1988).

claim they justifiably relied on Weinberg and Green's failure to act in entering the agreement.

An aiding and abetting claim has, at a minimum, three requirements: (1) a primary violation by a primary party; (2) knowledge of the violation; and (3) substantial assistance in the achievement of the primary violation.[26] Bloor v. Carro, Spanbock, Londin, Rodman and Fass, 754 F.2d 57, 62 (2d Cir. 1985); Monsen v. Consolidated Dressed Beef Co., Inc., 579 F.2d 793, 799 (3d Cir.), cert. denied, 439 U.S. 30 (1978). But see, Schlifke, 866 F.2d at 947 (requiring that a plaintiff must show that the alleged aider and

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[26] Some courts have said that the last two prongs of the test should be considered relatively so that the less evidence there is of assistance, the greater the degree of knowledge required to be proven. Metge, 762 F.2d at 624; Woodward v. Metro Bank of Dallas, 522 F.2d 84, 95 (5th Cir. 1975). However, when "proof is lacking on any one part . . . there can be no liability." Stokes v. Lokken, 644 F.2d 779, 784 (8th Cir. 1981).

abettor committed a manipulative or deceptive act proscribed under 10(b) and 10b-5 with the same degree of scienter required for primary liability).

Under common law theories of aider and abettor liability, it is not essential that a defendant actually provide affirmative assistance. Rather, it may be sufficient if one is present, ready, willing and able to render assistance if required. Under these circumstances, it is necessary that the primary violator know of - and receive encouragement from - the intent of the secondary party to be of assistance. In the securities area, the cases speak of a "high conscious intent" and a "conscious and specific motivation to aid and abet fraud." See, e.g., Martin v. Pepsi-Cola Bottling Co., 639 F. Supp. 931, 935 (D.Md. 1986) (Young, J.). As put by Judge Heaney, in Metge, 762 F.2d at 625: "[I]n the absence of a duty to act or disclose, an

aider-abettor case predicated on inaction of the secondary party must meet a high standard of intent." Here, plaintiffs rely on their allegations of affirmative substantial assistance in closing the deal, and do not appear to premise liability in this count on inaction by Weinberg and Green.

Weinberg and Green argues that plaintiffs cannot meet the second prong of the test because they fail to allege a conscious intent to aid Rosenberg and a duty to the plaintiffs requiring disclosure of known misrepresentations. Further, as to the third prong, defendant argues that its alleged actions do not meet the requirements of "substantial assistance" for the purposes of aiding and abetting liability.[27] Although as a matter of proof,

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[27] Defendant challenges plaintiffs' §12(2) claim on the additional ground that to be liable for aiding and abetting, one must be a statutory seller under §12(1)'s (continued...)

these two elements may vary inversely, it is still necessary for a plaintiff to allege both when affirmative assistance is at issue. A fatal flaw in plaintiffs' allegations can be found in the third element, that of substantial assistance.

The "substantial assistance" requirement is described in Landy v. Federal Deposit Insurance Corp., 486 F.2d 139, 163 (3d Cir.), cert. denied, 416 U.S. 960 (1973), as follows:

> If the encouragement or assistance is a substantial factor in causing the resulting tort, the one giving it is himself a tortfeasor and is responsible for the consequences of the other's act.

(Referring to Restatement of Torts §436). Later cases have stated that substantial

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[27](...continued) definition set out in Pinter v. Dahl, 108 S.Ct. 2063 (1988), citing Wilson v. Saintine Exploration & Drilling Corp., Fed. Sec. L. Rep. ¶94,358 (2d Cir. 1989) and Craftmatic Securities Litigation, Fed. Sec. L. Rep. ¶94,805 (3d Cir. 1989). Fortunately, it will not be necessary to decide this question.

assistance requires an allegation that the actions of the aider and abettor "proximately caused the harm [to the plaintiff] on which the primary liability is predicated." Bloor, 754 F.2d at 62 (footnote omitted). Accord, First Interstate Bank of Nevada v. Chapman and Cutler, 837 F.2d 775, 779 (7th Cir. 1988); Metge v. Baehler, 762 F.2d 621, 624 (8th Cir. 1985), cert. denied 474 U.S 1057 (1986).

The plaintiffs here have alleged that had Weinberg and Green disclosed the misrepresentation or withdrawn from representing Rosenberg they would not have entered the agreement. (¶45). Proximate cause involves more than that and this mere "but for" allegation alone is not enough to make out an aiding and abetting claim. The test is whether Weinberg and Green was a substantial factor in bringing about Rosenberg's fraud. Nowhere, in the many

pages of opposition, do plaintiffs even hint at what Weinberg and Green did to cause Rosenberg to commit fraud. They devote the entire section on aiding and abetting (pp. 20-29) discussing scienter and intent. But without some assistance in causing the misrepresentation, this claim cannot succeed.

Reliance on Adalman v. Baker, Watts & Co., 807 F.2d 359 (4th Cir. 1986), is misplaced. Plaintiffs confuse the use of the substantial assistance test as it applies to define "seller" under ¶12(2), for purposes of a primary violations, with the substantial assistance prong of aiding and abetting liability. The former, which was at issue in Adalman, focuses on what help the defendant provided in bringing about the sale. The latter focuses on what help the defendant provided to the primary violator in committing the misrepresentation.

Rosenberg is not alleged to have used Weinberg and Green's help in first misrepresenting his financial situation. Nor do plaintiffs claim that Weinberg and Green's assistance was necessary to Rosenberg's misrepresentations in the financial statements. Rather, Weinberg and Green's actions facilitated drafting documents and preparing for the closing. Without a single allegation that Weinberg and Green assisted Rosenberg in making the critical misrepresentations, the aiding and abetting claim must fail.

Accordingly, it is respectfully recommended that Count VI dealing with aider and abettor liability be dismissed.

IV. Misrepresentation

Count VII

In Count VII, plaintiffs allege that the conduct of Weinberg and Green "violated applicable duties imposed upon an attorney

and agent by the law of the State of Maryland to not knowingly or recklessly perpetuate or assist in misrepresentations." (¶149). This duty allegedly required them either to withdraw from representation of Rosenberg or to disclose his material representations to the plaintiffs. Plaintiffs stated that they justifiably relied on the conduct of Weinberg and Green in entering into the agreement and suffered damages proximately caused by that conduct. (¶¶150-153). In their opposition to Weinberg and Green's motion to dismiss, the plaintiffs state that:

> for the same reasons that Ivan and Joanne Schatz have pleaded a viable cause of action against Weinberg and Green for securities fraud, either on a primary or aiding and abetting theory of liability, they have pleaded a cause of action against Weinberg and Green for misrepresentation under Maryland law.

(Paper No. 74 at 41-42).

Weinberg and Green moves to dismiss arguing that (1) absent an affirmative misrepresentation made by it, it had no duty to disclose its client's misrepresentations; (2) plaintiffs have not alleged a misrepresentation by Weinberg and Green; and (3) the Professional Rules of Responsibility, in particular, Rule 7-102(B), create no duty or liability from an attorney to third parties.[28]

In order to state a claim for misrepresentation (deceit) under Maryland law, one must allege:

> (1) that the representation made is false; (2) that its falsity was either known to the speaker, or the misrepresentation was made with such a reckless indifference to truth as to be equivalent to actual knowledge; (3) that it was made for the purpose of defrauding the person claiming to be injured thereby; (4) that such person not only relied upon the misrepresentation, but had a

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[28] Incorporated into its motion is defendants' argument on this count in the original complaint. (Paper No. 8, pp. 6-11).

> right to rely upon it in the full belief of its truth, and that he would hot have done the thing from which the injury result had not such misrepresentation been made; and (5) that he actually suffered damage directly resulting from such fraudulent misrepresentation.

Martens Chevrolet, Inc. v. Seney, 292 Md. 328, 333, 439 A.2d 534, 539 (1982). As in a securities action under §10(b), absent a duty, mere silence or failure to disclose material facts does not generally constitute actionable fraud under Maryland law. Under some circumstances, though, a failure to disclose may be actionable, such as where it is coupled with an affirmative misstatement. Walsh v. Edwards, 233 Md. 552, 197 A.2d 424, 427 (1964).

The analysis of the plaintiffs' claim for this common law action parallels that for the securities claims. Absent sufficient allegation of duty, liability can only be premised on affirmative misrepresentations by Weinberg and Green

or, at least, substantial assistance to Rosenberg. This claim should be dismissed, albeit with leave to amend if, in fact, ¶55 is meant to encompass allegations of direct misstatements by Weinberg and Green.

V. Bankruptcy Issues

Mr. Rosenberg has, as all now know, filed for personal bankruptcy. He claims that the RICO claim for treble damages (assuming it survives the motion to dismiss) as well as the claims for punitive damages and attorneys' fees under the other counts are dischargeable in that bankruptcy and should be dismissed from this action. Plaintiffs respond (1) that damages for injuries that were willfully and maliciously inflicted are not dischargeable, and (2) that the issue should be deferred until a jury has determined liability.

Plaintiffs assert that there are potentially at least two categories in 11

U.S.C. §523 under which the claims would be excepted from discharge:

> §(a)(2): a debt for money to the extent obtained (A) by actual fraud or (B) by use of a materially false statement in a writing, and
>
> §(a)(6): a debt for willful and malicious injury.

Mr. Rosenberg argues that only the more specific category can be applicable and that, if the provisions of §a(2)(A) or (B) are not met, then the debt <u>is</u> dischargeable.

Rosenberg's sole argument for applying only a(2) is that general rules of statutory construction require application of the more specific provision in precedence to the more general provision, citing 2A N. Singer, <u>Sutherland on Statutory Construction</u> at 501 (4th ed. 1984) (Sutherland). That, of course, is only part of the analysis. In context, the general rule is:

> Where one statute deals with a subject in general terms, and another deals with a part of the same subject in a more detailed way, the two should be harmonized if possible; but if there is any conflict, the latter will prevail, regardless of whether it was passed prior to the general statute, unless it appears that the legislature intended to make the general act controlling.[29]

This argument should be rejected. First, the relationship of (a)(2) to (a)(6) is not necessarily specific to general and, second, the proper overall interpretation of §523 does not compel that result.

Rosenberg cites no cases for the proposition that any particular claim must be measured against only one category. The case relied upon by plaintiffs, on the other hand, <u>considered</u> whether the claim was excepted from discharge under §523(a)(2), (4) and (6) and <u>concluded</u> that the punitive damages were <u>not</u> dischargeable

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[29] This general rule applies to various provisions in a single statute, if unreconcilable. Sutherland §46.05 at 92.

under §523(a)(4) and (6), In re Austin, 93 B.R. 723 (Bkrtcy.D. Colo. 1988). Accord, In re Kroh, 88 B.R. 972, 986 (Bkrtcy.W.D.Mo. 1988) (punitive damages for willful and malicious injury not dischargeable under §523(a)(6)).

The case cited by Rosenberg, Matter of Suter, 59 B.R. 944 (Bkrtcy.N.D.Ill. 1986), considered only whether RICO treble damages were excepted from discharge under §523(a)(2)(A).[30] In concluding that they were not so exempt, the court took solace from the fact that its result harmonized with §523(a)(7). There is no mention whatsoever of §(a)(6).

It is respectfully recommended that Rosenberg's motion to dismiss the RICO claim for treble damages, punitive damages, and attorneys' fees on the ground that any such debts have been discharged in

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[30] The court did not decide the issue with regard to attorneys' fees, 59 B.R. at 947 and n.8.

bankruptcy be denied. While the general purpose of bankruptcy is to grant a debtor a "fresh start" and, thus, the exceptions to discharge in §523 are each to be narrowly construed, there is no valid reason to preclude plaintiffs from proving that any damages awarded here are debts for willful and malicious injury under §(a)(6) even if they do not fit within §(a)(2). Proof of willful and malicious injury may require proof beyond that necessary to prove fraud and thus should be analyzed separately. At this point, it cannot be said as a matter of law that plaintiffs can prove no set of facts giving rise to nondischargeability under §523.

Mr. Rosenberg also contends that plaintiffs are limited to filing a proof of claim in bankruptcy court and may not proceed against him in this court. Plaintiffs, on the other hand, assert that Chief Judge Harvey already ruled that this

action is properly before this Court when he withdrew the reference to bankruptcy court. Plaintiffs are correct. This case began by the filing of an adversary proceeding in bankruptcy court. On November 22, 1989, the bankruptcy court approved a Stipulation and Settlement Agreement resolving the status of the Schatz' claim in the bankruptcy proceeding. That settlement has no effect on this suit. Once the issues in Count I through V against Rosenberg are determined, the Court will have to address Count VIII, i.e., whether any amounts awarded against Rosenberg were excepted from discharge in bankruptcy. At that time, the matter can be decided by the Court or referred to the bankruptcy court for determination. In any event, this complaint should not be dismissed because of the bankruptcy filing.

VI. Conclusion

For the foregoing reasons, it is respectfully recommended that the motions to dismiss be granted in part as follows:

1. Count I (RICO) be dismissed against all defendants for failure to allege a pattern.

2. Counts II and III be dismissed, unless amended to overcome the statute of limitations problems.

3. Counts III, VI and VII, against Weinberg and Green be dismissed. (Counts III and VII may be subject to amendment if particular allegations of affirmative misrepresentation can be made).

The motions to dismiss (and partial motion for summary judgment) should otherwise be denied, leaving Count IV (securities fraud against Rosenberg and MER), Count V (common law fraud against Rosenberg and Jaeger) and

Count VIII (declaration of dischargeability), in tact.

DEBORAH K. CHASANOW
United States Magistrate

Date

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND

IVAN N. SCHATZ, _et al._	)	
	)	
v.	)	Civil No.
	)	JH-89-705
MARK R. ROSENBERG,	)	
_et al_.	)	

MEMORANDUM OPINION

The matter now pending for the Court's consideration is Magistrate Chasanow's comprehensive report and recommendation on the defendants' motions to dismiss, which recommends that Counts I, II, III, VI, and VII be dismissed. Plaintiffs Ivan and Joanne Schatz and defendant Weinberg & Green have filed objections to the report. Defendants Mark E. Rosenberg (Rosenberg) and MER Enterprises, Inc. (MER) have filed a response to the plaintiffs' objections. Upon _de novo_ consideration of the report, the record, and the objections and responses submitted, the Court shall adopt the report and recommendation in full,

except that the Court will dismiss Counts I, III, VI, and VII without leave to amend.

In December 31, 1986, MER purchased and 80% interest in two companies the plaintiffs owned, Virginia Adjustable Bed Manufacturing Corp. (VAMCO) and Advanced Bed Concepts (ABC). MER is a holding company which Mark Rosenberg created to purchase the stock of these two companies. Mark Rosenberg and Stephen H. Jaeger, a former senior vice-president for First American Bank of Maryland, also joined the agreement. Mr. Jaeger had been responsible for handling loan transactions for the many companies Mr. Rosenberg owned, which included Yale Sportswear Corp. (Yale), the Back Center, Inc. (BCI), and Vertech Management Corp. (Vertech).

As payment for their 80% interests in VAMCO and ABC, Mr. and Mrs. Schatz received $1.5 million in promissory notes which Mr. Rosenberg personally guaranteed. The

plaintiffs relied on a financial statement dated March 31, 1986 and an update letter delivered at closing which indicated that Mr. Rosenberg's net worth exceeded $7 million. These financial documents contained several misrepresentations and in reality, Mr. Rosenberg's financial empire crumbled between April and December of 1986. Yale filed for bankruptcy in September 1987 and Mr. Rosenberg filed for personal bankruptcy thereafter. The law firm of Weinberg & Green represented Mr. Rosenberg and his entities throughout this entire period.

The plaintiffs never received payment on their promissory notes and lost an additional $150,000 when they made a "bridge loan" to BBC, the company that was formed when VAMCO and ABC merged with BCI. As a result of this economic loss and the misrepresentations made, the plaintiffs have filed a seven-count complaint

asserting: a violation of the Racketeer Influenced and Corrupt Organizations Act (RICO) against defendants Rosenberg and Jaeger (Count I), violations of §10(b) of the Securities Exchange Act of 1934 against Rosenberg and Jaeger (Count II), and Weinberg & Green (Count III), violations of §12 of the Securities Act of 1933 against Rosenberg and MER (Count IV), common law fraud against Rosenberg and Jaeger (Count V), aiding and abetting liability under the securities laws against Weinberg & Green (Count VI), common law misrepresentation against Weinberg & Green (Count VIII), and declaration of non-dischargeability in bankruptcy of debts owed by Rosenberg. (Count VIII).

In their motions, defendants Rosenberg and Jaeger challenge plaintiffs' RICO claim for failure to allege a pattern of racketeering activity. Relying on the Supreme Court's recent decision in <u>H.J.,</u>

Inc.v. Northwestern Bell Telephone Co., 109 S. Ct. 2893 (1989), and this Circuit's recent decision in Menasco, Inc. v. Wasserman, 886 F. 2d 681 (4th Cir. 1989), Magistrate Chasanow concluded that plaintiffs' complaint describes a closed ended scheme. (Magistrate's Report at 15). Because this scheme involved two defendants with one goal (maintaining the viability of Rosenberg's entities), five victims, and acts spanning over a 1 1/2 year period without threat of repetition, Magistrate Chasanow recommended that this count be dismissed without prejudice, pursuant to the Fourth Circuit's suggestion for RICO claims filed prior to the Supreme Court's opinion in H.J., Inc. Menasco, 886 F. 2d at 685. The relevant parties have addressed this issue in their objections.

This Court shall dismiss Count I with prejudice because it is factually dissimilar to Menasco. There, the lower

court did not permit the plaintiffs to amend their complaint at all, and on appeal, the "[p]laintiffs claimed that if permitted leave to amend, they would clearly and unequivocally establish the existence of a pattern of racketeering activity." 886 F. 2d 681. The plaintiffs asserted they would allege a scheme involving approximately twenty-five victims. The Fourth Circuit held that if plaintiffs did plead these allegations with sufficient particularity, this would satisfy H.J., Inc.'s requirement of a "'regular way of conducting defendant's ongoing legitimate business...that carries with it a distinct threat of future racketeering activity'" Id.

In their objections, plaintiffs do not claim that they can allege a pattern of racketeering activity with respect to other victims, nor can they allege facts to support a distinct threat of future

racketeering activity, because the scheme which they describe ended when Yale filed for bankruptcy. Because it appears futile to grant plaintiffs yet a third opportunity to amend their complaint, the Court shall dismiss Count I without leave to amend.

Magistrate Chasanow recommended dismissal of Counts II and III, alleging claims under §10(b) of the 1934 Act, because the plaintiffs have not affirmatively established that they brought this action within one year after discovering defendant's misrepresentations as required by 15 U.S.C. §77m.

Counts II and III are silent as to when the plaintiffs discovered the defendants' misrepresentations. The first reference to this occurs in Count IV, a claim under §12 of the 1933 Act, where Mr. and Mrs. Schatz first assert that they "could not have known of such misrepresentations and omissions until

September of 1987 when Yale declared bankruptcy." (Para. 125). Count VI, which asserts a claim for aider and abetter liability incorporates paragraph 125. Therefore, the plaintiffs have failed to meet their burden of proving that Counts II and III were brought timely.

Because reference is made elsewhere in the complaint regarding discovery of the defendants' misrepresentations, omission of this fact in Counts II and III is a technical error. Accordingly, leave to amend these counts should be granted.[31]

Count IV asserts a claim under §12 of the Securities Act of 1933 against defendants Rosenberg and MER. These defendants urged the Court to convert this portion of the motion to a motion for summary judgment, which the Magistrate did,

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[31] Weinberg & Green has also moved to dismiss this count for failure to state a claim. On this alternative ground, this Court finds that dismissal without leave to amend is proper. <u>Infra</u>, at p. 10.

pursuant to the Fourth Circuit's dicta in Rivanna Trawlers v. Thompson Trawlers, 840 F. 2d 71 (2d Cir. 1989).

These defendants assert that the promissory notes in dispute were not securities. The Magistrate's report contains a most comprehensive discussion of the various tests the circuits have employed in resolving this issue--the commercial investment test, the economic realities test, and the investment contract test.

Critical to both the commercial investment and the investment contract tests is the degree to which the plaintiff is dependent upon the efforts of others to realize a profit on his investment. The agreement between the parties points out that even though Mr. Schatz was president of the Back Companies,[32] MER had at least a

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[32] The Back Companies are defined as BCI, Vertech, VAMCO and ABC.

50% ownership interest in Yale Sportswear Corporation. The Magistrate concluded that this fact raises a question as to whether Mr. Rosenberg's efforts in managing Yale were significant enough to convert these promissory notes into securities, and therefore, summary judgment must be denied.

Since the report was issued, the Supreme Court has rejected the investment contract test as applied to promissory notes and announced its preference for the Second Circuit's family resemblance test in Reeves v. Ernst & Young, 58 U.S.L.W. 4208 (February 21, 1990). The family resemblance test is similar to the commercial investment test, which several judges within this circuit have cited with approval. See e.g., South Carolina National Bank v. Darmstetter, 622 F. Supp. 226, 229 (D.C.S.C. 1985) aff'd, 813 F. 2d 403 (4th Cir. 1986), cert. denied, 479 U.S.

1065 (1987); Oliver v. Bostetter, 426 F. Supp. 1082, 1085 (D. Md. 1977).

The family resemblance test looks first to the Securities Acts, which define "security" as including any note; therefore there is a rebuttable presumption that every note is a security. 58 U.S.L.W. 4210. Typically excluded from this category are notes delivered in consumer financing, notes secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, notes evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or notes which simply formalize an open-account debt incurred in the ordinary course of business. 58 U.S.L.W. 4210, citing, Exchange National Bank of Chicago v. Touche Ross & Co., 544 F. 2d 1126, 1137 (2d Cir. 1976).

The Court in Reeves expanded the Second Circuit's test by requiring consideration of four additional factors. First, if the seller's purpose is to raise money for a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a security. Second, courts must determine whether the note is an instrument in which there is common trading for speculation or investment. Third, courts should consider the reasonable expectations of the investing public, and finally, whether some other regulatory scheme exists which would significantly reduce the risk of the investment. 58 U.S.L.W. 4210-11. (citations omitted).

The promissory notes in question do not fall within the category of either a consumer or short-term business loan, which are typically excluded from the Second

Circuit's definition of a security. Moreover, Mr. Rosenberg was interested in financing a substantial investment and the plaintiffs were interested in realizing a profit from these notes. Therefore, from both sides, the transaction was most naturally conceived as an investment in a business enterprise, rather than as a purely commercial or consumer transaction. Id., 58 U.S.L.W. 4211. Because these promissory notes were uncollateralized and uninsured, no regulatory scheme exists which would have significantly reduced the risk of these instruments. Id.

However, in reviewing the plan of distribution, there is no evidence to suggest that these notes involved "'common trading for speculation or investment.'". 58 U.S.L.W. 4210. Nor is there any evidence regarding the public's reasonable expectations that these notes were securities, because they were not offered

to a broad segment of the public. Because it is unclear whether these promissory notes are securities under Reeves, summary judgment cannot be granted.

Count III against Weinberg & Green alleges primary liability under §10(b) of 1934 Act, which makes it unlawful for any person, directly or indirectly, in connection with the purchase or sale of a security to use or employ any "manipulative or deceptive device or contrivance in contravention [of federal securities regulations]."

The elements of primary liability include: (1) an untrue statement of material fact or an omitted material fact that rendered the statements made misleading, (2) in connection with a securities transaction, (3) with the intent to mislead, and (4) which caused a plaintiff's loss. Schlifke v. Seafirst Corp., 866 F. 2d 935, 943 (7th Cir. 1989).

If liability is based on nondisclosure, there can be no fraud absent a duty to speak. Chiarella v. United States, 445 U.S. 222, 235 (1980). A duty to disclose arises not from the securities regulations, but rather, from a relationship of trust and confidence and trust and confidence between parties to a transaction.

In recommending that this count be dismissed without prejudice, Magistrate Chasanow found that the plaintiffs did not allege a relationship with Weinberg & Green that would give rise to an independent duty to disclose to them, nor did they allege that the law firm made any affirmative misrepresentations.

Similarly, Magistrate Chasanow recommended that plaintiffs' securities claim charging Weinberg & Green with aider and abettor liability be dismissed. In order to withstand defendants' motion, the plaintiffs must show: (1) a primary

violation by a primary party; (2) knowledge of the violation; and (3) substantial assistance in the achievement of the primary violation. Bloor v. Carro, Spanbock, Londin, Rodman and Fass, 754 F. 2d 57, 62 (2d Cir. 1985). The report recommends dismissal of this claim, because, "[n]owhere, in the many pages of opposition, do plaintiffs even hint at what Weinberg & Green did to cause Rosenberg to commit fraud." (Report at 41).

The Schatz' third and final claim against Weinberg & Green for misrepresentation is also deficient for the same reason as their claim for primary liability under §10(b); absent a duty, mere silence or failure to disclose material facts does not generally constitute actionable fraud under Maryland law. Martens Chevrolet, Inc. v. Seney, 292 Md. 328, 333, 439 A. 2d 534, 539 (1982). As with Count III, Magistrate Chasanow

recommends that this claim be dismissed, with leave to amend.

Weinberg & Green's sole objection to the report is to the recommendation that Counts III and VII be dismissed with leave to amend. They persuasively urge this Court to dismiss these claims with prejudice because the "'salutary objective'" of granting leave to amend yet a third time is "'outweighed by equally compelling policy considerations.'" (Objections of Weinberg and Green at 4, citing, Sanders v. Thrall Car Manufacturing Co., 582 F. Supp. 945, 952 (S.D.N.Y. 1983) aff'd, 730 F. 2d 910 (2d Cir. 1984)).

While leave to amend should be freely granted absent undue delay, bad faith or dilatory motive, Foman v. Davis, 371 U.S. 178, 182 (1962), courts should consider whether the plaintiff has belatedly moved to amend after his opponent has fully briefed a motion to dismiss or for summary

judgment. Sandcrest Outpatient Services v. Cumberland County Hospital, 853 F. 2d 1139, 1148-49 (4th Cir. 1988); Sanders v. Cumberland, supra, 582 F. Supp 945, 952. This Court concludes that it is proper to dismiss Counts III and VII without leave to amend. The plaintiffs have had three opportunities to attribute affirmative misstatements to this defendant and they have failed to do so. This Court would grant leave to amend had plaintiffs claimed in their objections to the report that they could allege such misrepresentations. However, they merely restate their previous arguments. Accordingly, the salutary objective for granting leave to amend is outweighed by countervailing policy considerations and shall be denied.

Finally, Mr. Rosenberg has moved to dismiss plaintiffs' claims for punitive damages and attorneys' fees on the ground that these are dischargeable in bankruptcy.

This Court agrees with Magistrate Chasanow that at this point, it cannot be said as a matter of law that plaintiffs can prove no set of facts giving rise to nondischargeability under §523 of the Bankruptcy Code.

The Court is grateful to Magistrate Chasanow for her persuasive and meticulously-well researched report and recommendation.

The Court shall enter a separate consistent with this opinion.

Date	Joseph C. Howard United States District Judge

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND

IVAN N. SCHATZ, _et al._ Plaintiffs	)	
v.	)	Civil No. JH-89-705
MARK R. ROSENBERG, _et al._ Defendants	)	

ORDER

Upon _de novo_ review of the report and recommendation of the Honorable Deborah K. Chasanow dated January 24, 1990, the record, the objections of defendant Weinberg and Green and the plaintiffs, as well as the responses of defendants Mark E. Rosenberg (Rosenberg) and MER Enterprises, Inc. (MER), it is this 8th day of March, 1990, by the United States District Court for the District of Maryland, ORDERED:

1. that the report and recommendation dated January 24, 1990 BE, and the same hereby, IS ADOPTED, but for that portion

that recommends that Counts I, III, and VII be dismissed without leave to amend; and

2. that defendants Rosenberg and Stephen H. Jaeger's (Jaeger) motion to dismiss Count I BE, and the same hereby IS, GRANTED; and

3. that defendants Rosenberg and Jaeger's motion to dismiss Count II BE, and the same hereby IS, GRANTED. Plaintiffs may amend this count within twenty (20) days of the date of this Order; and

4. that defendant Weinberg and Green's motion to dismiss Counts III, VI, and VII, BE, and the same hereby IS, GRANTED,

5. that defendants Rosenberg and MER's motion to dismiss Count IV, which has been converted to a motion for summary judgment BE, and the same hereby IS, DENIED; and

6. that defendants Rosenberg and MER's motion to dismiss Count V and VIII, bE, and the same hereby IS, DENIED; and

7. that the Clerk mail copies of this Order and the foregoing memorandum opinion to the Honorable Deborah K. Chasanow and counsel of record.

Joseph C. Howard
United States
District Judge

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND

IVAN N. SCHATZ, _et al._ Plaintiffs v. MARK E. ROSENBERG, _et al._ Defendants	))))))))))	Civil No. JH-89-705

MEMORANDUM AND ORDER

Presently before the Court is plaintiffs' motion for reconsideration of the Court's March 8, 1990 Order dismissing the counts in the complaint pertaining to defendant Weinberg and Green. Defendant has filed an opposition. With these memoranda, the Court determines the motion is ready for disposition. No hearing is deemed necessary. Local Rule 105.6.

Plaintiffs' motion for reconsideration is grounded upon an opinion they sought from the Maryland State Bar Association's Committee on Ethics (the "Committee")

regarding a law firms ethical obligation to disclose the misrepresentations of a client. (Paper No. 115, Ex. A). In requesting the opinion, plaintiffs' factual scenario refers to a law firm "with actual knowledge of the misstatements." Id.

The Committee's conclusion that ". . . the attorney would be obligated to disclose . . . material facts underlying its clients fraud," was clearly premised upon the scenario described by plaintiff in which the law firm had "actual knowledge" of its clients misstatements. (Plaintiffs' Ex. B). Plaintiffs assert that the Committee's opinion "shows what Maryland public policy is concerning these facts" and they contend that, in dismissing the defendants, the Court did not adequately consider "the public policy considerations underlying the Code and Disciplinary Rules."

Although the Court has the utmost respect for the Committee, its opinion is

not relevant to this case. Plaintiffs have never alleged that the defendant had actual knowledge of misstatements by its client, a fact the Committee was led to believe existed in the hypothetical posed to them. Indeed, the Court noted in the Memorandum Opinion that accompanied its March 8 Order dismissing defendant that "plaintiffs did not allege a relationship with Weinberg and Green that would give rise to an independent duty to disclose to them, nor did they allege that the law firm made any affirmative misrepresentations." (Mem Op. at 9). Additionally, in denying plaintiffs leave to amend, the Court observed that "plaintiffs have had three opportunities to attribute affirmative misstatements to this defendant and they have failed to do so." (Mem Op. at 10). Therefore, the Court finds no basis for plaintiffs' motion.

Accordingly, it is this 15th day of October, 1990, by the United States

District Court for the District of Maryland;

ORDERED:

(1) That plaintiffs' motion for reconsideration BE, and the same hereby is, DENIED; and

(2) That the Clerk of the Court mail copies of this Order to counsel of record.

Joseph C. Howard
United States
District Judge

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

FILED
October 1, 1991

No. 90-1889

IVAN N. SCHATZ; JOANN B. SCHATZ

Plaintiffs - Appellants

v.

MARK E. ROSENBERG; MER ENTERPRISES, INC.
STEPHEN JAEGER; WEINBERG & GREEN

Defendants - Appellees

On Petition for Rehearing with Suggestion for Rehearing In Banc

---

Appellant filed a petition for rehearing with suggestion for rehearing in banc. No member of the Court requested a poll on the suggestion for rehearing in banc, and the original judicial panel voted to deny the petition for rehearing.

The Court denies the petition for rehearing with suggestion for rehearing in banc.

Entered at the direction of Judge Chapman, with the concurrence of Judge Wilkinson and Judge Hilton, United States District Judge, sitting by designation.

For the Court,

Clerk

Applicable statute and regulation
15 U.S.C. § 78(b)

Regulation of the Use of Manipulative and Deceptive Devices

Sec. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange--

* * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

* * * *

Employment of Manipulative and

Deceptive Devices

Rule 10b-5. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

No. 91-1062

IN THE
Supreme Court of the United States
OCTOBER TERM, 1991

IVAN SCHATZ, *et al.*,
Petitioners,
v.
WEINBERG AND GREEN,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

BRIEF IN OPPOSITION

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QUESTION PRESENTED

Should § 10(b) of the Securities and Exchange Act of 1934 and SEC Rule 10b-5 be judicially extended to make attorneys liable for failure to disclose to an adverse party the financial condition of their own client, when the attorneys simply prepared closing documents, had no relationship of trust and confidence with the adverse party, and neither negotiated, solicited, nor made any representation whatsoever concerning the transaction?

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In The

Supreme Court of the United States

October Term, 1991

No. 91-1062

Ivan Schatz, *et al.*,

Petitioners,

v.

Weinberg and Green,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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BRIEF IN OPPOSITION

OPINIONS BELOW

The opinions of the United States Magistrate (Pet. App. 51) and of the District Court (Pet. App. 136) are unreported. The opinion of the Court of Appeals is reported at 943 F.2d 485 (Pet. App. 1).

JURISDICTION

The judgment of the Court of Appeals was entered August 26, 1991. A petition for rehearing was denied October 1, 1991. The petition for a writ of certiorari was filed December 30, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254.

STATEMENT

Petitioners, sellers of stock in two businesses, sued the guarantor of the purchaser's notes, claiming that the guarantor had misrepresented his worsening financial situation that led to his ultimate bankruptcy and inability to pay the notes. In addition, petitioners sued respondent, the law firm the guarantor retained after the sale had been negotiated to prepare the closing documents.

No allegation was made that respondent had prepared any financial statements for its clients; that it had prepared any solicitations; that it had participated in the negotiations leading to the sale; that it had offered any false or misleading opinion letter; or that it had made any representation whatsoever to petitioners. What was alleged was that respondent had been silent about its client's financial condition; and that respondent as the guarantor's attorneys had drafted the closing documents, and then delivered them along with a letter from the guarantor concerning his financial condition for review to petitioners' counsel, the Washington, D.C. law firm of Arent, Fox, Kintner, Plotkin & Kahn.

Petitioners filed three successive complaints. The first, which they first filed in the United States Bankruptcy Court for Maryland and then were allowed to transfer to the United States District Court, in addition to various claims against the client, charged respondent simply with misrepresentation under Maryland law. When respondent moved to dismiss under Rule 12(b)(6), Fed. R. Civ. P., for failure to state a claim, petitioner then filed an amended complaint, which added a charge that respondent had aided and abetted alleged violations by the client of § 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10 5b, and § 12 of the Securities Act of 1933, 15 U.S.C. § 77*l*. After respondent again moved to dismiss, petitioners filed yet another amended complaint, adding a claim that respondent itself by failing to disclose its

client's financial situation had violated § 10(b) and Rule 10b-5. Respondent for the third time moved to dismiss.

On reference from the District Judge, a United States Magistrate recommended that the latest complaint be dismissed as to respondent for failure to state a claim on which relief could be granted. Pet. App. 51. The District Judge (Howard, J.) on *de novo* review agreed, noting agreement with the Magistrate's observation that "[n]owhere, in the many pages of opposition, do plaintiffs even hint at what Weinberg & Green did to cause Rosenberg [the guarantor] to commit fraud." Pet. App. 151. The District Court pointed out that the alleged violation of § 10(b) was based on nondisclosure, rather than any misrepresentation by respondent. The Court relied on this Court's holding in *Chiarella* v. *United States*, 445 U.S. 222 (1980), that "when an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." 445 U.S. at 235. Pet. App. 150.

The United States Court of Appeals for the Fourth Circuit (Wilkinson, Chapman and Hilton, JJ.) affirmed. Relying as had the District Court on this Court's decision in *Chiarella* v. *United States, supra*, as well as *Dirks* v. *SEC*, 463 U.S. 646 (1983), and similar holdings of the Fifth and Seventh Circuits, the Court of Appeals held that under § 10(b) of the Securities and Exchange Act, any duty to disclose must arise from the relationship of the parties, and does not exist unless there is "a fiduciary or other similar relation of trust and confidence." Pet. App. 14, quoting *Chiarella* v. *United States, supra*, 445 U.S. at 228. It explained that the law was well established that "a lawyer or law firm cannot be held liable for misrepresentation under section 10(b) for failing to disclose information about a client to a third party absent some fiduciary or other confidential relationship with the third party." Pet. App. 15. An attorney could be liable for making a false representation, the Court added, but none was alleged here. Pet. App. 32.

The Court of Appeals also affirmed dismissal of the aiding-and-abetting claim, citing many cases holding that such liability requires an allegation of "high conscious intent" and "conscious and specific motivation" to defraud. Pet. App. 41. The Court of Appeals also agreed with the District Court that Maryland law, like the federal securities laws, imposes no affirmative duty to disclose absent a relationship of trust. With respect to "public policy" arguments made by petitioners for extending nondisclosure liability to the opposite party's attorneys, the Court of Appeals observed that there were powerful reasons of policy for leaving the law as it is. Pet. App. 27-31.

REASONS FOR DENYING THE WRIT

The Court of Appeals here, affirming the District Court, simply followed an unbroken line of decisions of this Court and of other courts of appeals. There are no decisions in conflict. Moreover, the existing law reflects sound policy which, even if it were to be changed, should be changed by the Congress, and not by the courts.

I. THERE IS NO CONFLICT WITH ANY DECISION CONSTRUING § 10(b).

A. The Court of Appeals Followed the Decisions of this Court.

The Court of Appeals decided nothing new. It simply applied the holding of this Court in *Chiarella* v. *United States*, 445 U.S. 222 (1980), that

> "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak."

445 U.S. at 234-35. "[S]ilence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) . . . . But such liability is premised upon a duty to disclose arising from a relationship of

trust and confidence between parties to a transaction." *Id.* at 230. *Accord*, *Dirks* v. *SEC*, 463 U.S. 646, 657-58 (1983). That is precisely what the Court of Appeals held here. Pet. App. 15, 22-23.

B. There Is No Conflict in the Circuits.

Petitioners assert a conflict with two decisions of other courts of appeals. Those decisions are not even remotely in conflict with the Court of Appeals' ruling here.

Ikuno v. *Yip*, 912 F.2d 306 (9th Cir. 1990), the first case relied on by petitioners, arose under a wholly different statute, the Racketeer Influenced and Corrupt Organizations (RICO) Act, 18 U.S.C. § 1964. The court there held that summary judgment was inappropriate where there was a factual issue as to whether the defendant attorney had gone beyond legal representation, and had in fact also personally controlled the corporation accused of a fraudulent scheme.

Breard v. *Sachnoff & Weaver, Ltd.*, 941 F.2d 142 (2d Cir. 1991), did involve § 10(b) and Rule 10b-5. But in *Breard* the defendant attorneys had not simply prepared closing documents. They had gone beyond that and actually drafted solicitations that contained misrepresentations, intending that these be shown to prospective limited partners of the partnership they represented. In the present case, by contrast, "Weinberg and Green did not solicit any purchase of securities or prepare any solicitation documents. In fact, Rosenberg [the guarantor] and the Schatzes [the petitioners] worked out the details of the purchase of the business before involving the attorneys for either side." Pet. App. 22. Moreover, petitioners, unlike the solicited limited partners in *Breard*, did not even attempt to claim that the legal services performed by respondent were for their benefit, and thus that some duty was owed to them by respondent.

What the courts of appeals really have to say about the kind of new liability petitioners seek to create has

been very clear and very uniform. The Fourth Circuit is simply the latest in an unbroken line.

For example, the Seventh Circuit has held that when the claim is not one of misrepresentation, but rather of a "failure to 'blow the whistle,'" there is no liability under § 10(b) unless the defendant had "a *duty* to blow the whistle." *Barker* v. *Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 496 (7th Cir. 1986) (emphasis in original). It added that "[n]either lawyers nor accountants are required to tattle on their clients in the absence of some duty to disclose. . . . To the contrary, attorneys have privileges not to disclose." 797 F.2d at 497.

In another case on which the Court of Appeals here relied, the Fifth Circuit likewise held that an underwriter's counsel owed bondholders no duty under the securities laws to disclose inaccuracies in an offering statement for the bonds. "An attorney required by law to disclose 'material facts' to third parties might thus breach his or her duty, required by good ethical standards, to keep attorney-client confidences. Similarly, an attorney required to declare publicly his or her legal opinion of a client's actions and statements may find it impossible to remain as loyal to the client as legal ethics properly require." *Abell* v. *Potomac Ins. Co.*, 858 F.2d 1104, 1124 (5th Cir. 1988), *vacated on other grounds*, 492 U.S. 914 (1989) (footnote omitted).

Similarly, there are many court of appeals holdings that accountants have no duty under the federal securities laws to disclose their clients' financial information. *E.g., DiLeo* v. *Ernst & Young*, 901 F.2d 624 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990); *Latigo Ventures* v. *Laventhol & Horwath*, 876 F.2d 1322, 1327 (7th Cir. 1989) ("It is not the law that whenever an accountant discovers that his client is in financial trouble he must blow the whistle on the client for the protection of investors"); *Windon Third Oil and Gas Drilling Partnership* v. *FDIC*, 805 F.2d 342, 347 (10th Cir. 1986) (absent

fiduciary or other relationship of trust and confidence, accountant had no duty to disclose information about corporation's financial condition during discussions with potential investor), *cert. denied,* 480 U.S. 947 (1987).

C. No District Court Decisions Are in Conflict.

Petitioners also assert a conflict with three reported and two unreported decisions of federal district courts.[1] That, of course, would not be a reason for granting certiorari. See Supreme Court Rule 10. But even these decisions are in no wise inconsistent with the ruling in this case. No one disputes the general proposition that attorneys can be "liable to third parties for fraud." Pet. 6. No one suggests some sort of immunity. But, what matters here, no case has ever held that mere silence by an attorney who takes no part in the solicitation or negotiation of a securities transaction violates federal law. The district court cases that petitioners cite all involved attorneys who did more, as by preparing misleading opinion letters or solicitation documents to be given to investors.

II. NO DECISION CONFLICTS WITH THE HOLDING THAT AIDING AND ABETTING HAD NOT BEEN PLEADED.

With respect to aiding and abetting, the Court of Appeals simply held that the claim had not been adequately pleaded in petitioners' second amended complaint.

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[1] *In re Flight Transportation Corporations Securities Litigation,* 593 F. Supp. 612 (D. Minn. 1984); *Ahern* v. *Gaussoin,* 611 F. Supp. 1465 (D. Ore. 1985); *Rose* v. *Arkansas Valley Environmental and Utility Authority,* 562 F. Supp. 1180 (W.D. Mo. 1983); *Boltz* v. *Flagship Partners Limited Partnership,* unreported, No. 89 C 9103 (N.D. Ill. Aug. 22, 1990); *In re ZZZZ Best Securities Litigation,* unreported, No. CV 87-3574 RSWL (C.D. Cal. July 23, 1990).

Applying well settled law, it held that where as here the sum total of the allegations against an attorney were that the attorney "knowingly and/or recklessly provided substantial assistance" to the fraud, such an allegation did not meet the requisite "high conscious intent" and "conscious and specific motivation" to aid the fraud, the standard required by numerous appellate and district courts in those circumstances where, as here, no duty was owed by the alleged aider and abettor to the plaintiff. Pet. App. 41; *see, e.g., IIT* v. *Cornfeld*, 619 F.2d 909, 925 (2d Cir. 1980); *Woodward* v. *Metro Bank*, 522 F.2d 84, 97 (5th Cir. 1975); see also *Bloor* v. *Carro, Spanbock, Londin, Rodman & Fass*, 754 F.2d 57, 62 (2d Cir. 1985). When an attorney's actions constitute no more than "the daily grist of the mill," there is no liability for aiding and abetting in the absence of an allegation that petitioners' second amended complaint notably lacked—that of a clear intention to violate the securities laws. *Woodward* v. *Metro Bank, supra*, 522 F.2d at 97.

The Court of Appeals here accordingly held that to be liable for aiding and abetting, a defendant must have rendered substantial assistance to the primary securities law violation itself, and not simply to the person alleged to have committed the violation. Pet. App. 45. Because, according to petitioners' allegations, respondent merely reduced to writing the terms of a deal that had already been negotiated by the principals, committed no misrepresentations, and did not vouch for the accuracy of its clients' representations, which were given to petitioners' sophisticated counsel, the court below correctly held that its participation did not rise to the level of "substantial assistance." Pet. App. 46-47. Petitioners cannot, and do not, claim that the Court of Appeals' decision conflicts in this respect with any decision of any other court of appeals or, indeed, with any decision of any court anywhere.

III. THE SECURITIES LAWS DO NOT REQUIRE REVISION BY THIS COURT.

Petitioners assert that the Court of Appeals' decision immunizes attorneys from liability for fraud. Pet. 6, 11. But it does nothing of the kind. As the opinion makes clear, attorneys are no more immune from liability than anyone else—nor should they be—if they make an affirmative misrepresentation, if they fail to disclose what they have a duty to disclose to a person in a relationship of trust or confidence, or if they render intentional and substantial assistance to a wrongful act. All that the Court of Appeals did was to reaffirm a well-established legal standard. The Magistrate, the District Court, and the Court of Appeals concluded that petitioners' allegations, when measured against that clear legal standard, did not state a claim for violation of § 10(b) of the Securities and Exchange Act or SEC Rule 10b-5, or for aiding and abetting one.

Petitioners' argument, as they have recognized,[2] really is one of policy: that liability under the law should be expanded and extended to make attorneys liable for nondisclosure to an adverse party with whom they have no relationship of trust, when they neither engage in nor assist in negotiation or solicitation, and make no representation whatsoever. Perhaps an argument can be made that the law should be changed sometime to permit new lawsuits of this type. But the Court of Appeals pointed out that the policy considerations are by no means all on one side:

> "Attorney liability to third parties should not be expanded beyond liability for conflicts of interest. . . . Any other result may prevent a client from reposing complete trust in his lawyer for fear that he might

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[2] Petitioners argued, *inter alia*, that "this Court need look no further than basic public policy in finding a duty to disclose. We cannot live in a society which gives lawyers the right to assist in carrying out a fraud." Brief for Appellant, Fourth Circuit, at 31.

reveal a fact which would trigger the lawyer's duty to the third party. Similarly, if attorneys had a duty to disclose information to third parties, attorneys would have an incentive not to press clients for information. The net result would not be less securities fraud. Instead, attorneys would more often be unwitting accomplices to the fraud as a result of being kept in the dark by their clients or by their own reluctance to obtain information." Pet. App. 28-29.[3]

Most importantly, even if one concluded that petitioners were wholly correct as to what provisions would make ideal securities laws, and all the courts were wrong, such a change in the substantive scope of liability under the securities laws is more appropriately left to the Congress. "Formulation of such a broad duty, which departs radically from the doctrine that duty arises from a specific relationship between two parties, . . . should not be undertaken absent some explicit evidence of congressional intent." *Chiarella* v. *United States*, *supra*, 445 U.S. at 233; *cf.* also, *e.g.*, *INS* v. *Elias Zacarias*, 112 S. Ct. 812 (1992); *TVA* v. *Hill*, 437 U.S. 153, 194-95 (1978).[4]

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[3] As the Seventh Circuit similarly observed, in the parallel context of accountants:

> "Such a duty would prevent the client from reposing in the accountant the trust that is essential to an accurate audit. Firms would withhold documents, allow auditors to see but not copy, and otherwise emulate the CIA, if they feared that access might lead to destructive disclosure—for even an honest firm may fear that one of its accountant's many auditors would misunderstand the situation and ring the tocsin needlessly, with great loss to the firm."

DiLeo v. *Ernst & Young*, 901 F.2d 624, 629 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990), quoted by the Court of Appeals at Pet. App. 30. Moreover, "[l]aw firms and accountants may act or remain silent for good reasons as well as bad ones . . . ." *Barker* v. *Henderson, Franklin, Starnes & Holt*, *supra*, 797 F.2d at 497.

[4] In particular, this Court has consistently rejected attempts, even by the Securities and Exchange Commission, to extend the scope of § 10(b) of the Securities and Exchange Act. See, *e.g.*, *Dirks* v. *SEC*, *supra*; *Santa Fe Industries, Inc.* v. *Green*, 430 U.S.

CONCLUSION

For the reasons stated, certiorari should be denied.

Respectfully submitted,

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462, 471-73 (1977); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 214 (1976).